THE ECONOMIC OUTLOOK AND BUDGET CHALLENGES

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COMMITTEE ON THE BUDGET

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THE ECONOMIC OUTLOOK AND BUDGET CHALLENGES

TUESDAY, JANUARY 27, 2009

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to call, at 10:05 a.m. in room 210, Cannon House Office Building, Hon. John Spratt [chairman of the committee] presiding.

Present: Representatives Spratt, Schwartz, Kaptur, Doggett, Blumenauer, Boyd, McGovern, Tsongas, Etheridge, McCollum, Andrews, Edwards, Langevin, Larsen, Bishop, Connolly, Schrader, Ryan, Hensarling, Diaz-Balart, Simpson, Campbell, Jordan, Nunes, Aderholt, Lummis, Austria, and Harper.

Chairman SPRATT. I will call the hearing to order.

Today's hearing comes at a time of severe economic distress. Unemployment is at a 16-year high. In 2008 alone, 2.6 million jobs were lost. And each week seems to bring even more gloomy economic news. Whether one looks at the housing starts or foreclosure statistics or the balance in retirement plans, there is bad news all around us.

One role of this committee, a traditional role, is to keep an eye on the bottom line. But getting the economy back on track must take priority in this instance over getting the deficit down. We simply cannot afford to let this economy get away from us, so we must do what is necessary to boost a weakening economy.

At the same time, over the long run, we must also find a way to get the budget back on an even keel, on the path to being balanced again. And that, too, is part of our challenge today, to find some way to thread that narrow needle, serving the immediate interest of the country but also laying the foundation for the recovery and stabilization of the budget and the economy at this point in time.

Congress is at work on a plan as we speak to provide a substantial boost to the economy in the form of a strong economic recovery package. Both Congress and the Obama administration are looking at other steps that may be needed to stabilize the economy. Charting the right steps begins with an understanding of the economy, and that is the purpose of our hearing today.

As we continue our efforts to understand where things stand with the economy today and where things are headed, we are fortunate to have a very distinguished group of witnesses before us today. We will hear first from our new CBO director, Dr. Douglas Elmendorf.

This, I believe, Doug, is your first appearance as a witness for CBO.

Mr. ELMENDORF. Yes, sir.

Chairman SPRATT. We are glad to have you and glad to have you at the helm in particular.

Mr. ELMENDORF. Thank you.

Chairman SPRATT. When this committee met last week, we recommended to the Speaker of the House that Dr. Elmendorf become the next CBO director. Thursday afternoon Speaker Pelosi and Senate Pro Tempore Harry Reid appointed him to that position.

So we welcome Dr. Elmendorf, and we congratulate him.

We also want to acknowledge the hard work of Bob Sunshine.

Bob, stand up please.

[Applause.]

Chairman SPRATT. Over the last couple of months and in prior years as well, he has acted as acting director of the CBO, and as Alice Rivlin just reminded us in the back of the room, he was there when she was first there; he was there at the creation. And we have been fortunate to have him in his position as deputy director since 2007.

We are grateful to you, Bob, for your able work in the transition period and in particular for your service as the acting director.

On a second panel, we will hear from a number of distinguished economists: Dr. Alice Rivlin was the founding director of CBO and served as OMB director under President Clinton, and she currently serves as a senior fellow at Brookings. We will also hear from Dr. Mark Zandi, who is the chief economist and cofounder of Moody's Economy.com; Dr. Lawrence Meyer, who is a former member of the Board of Governors of the Federal Reserve, currently vice chairman of Macroeconomic Advisers; and Dr. Kevin Hassett, who is resident scholar and director of economic studies at AEI.

But before turning to our witnesses, let me turn to Mr. Ryan for any opening statement he may wish to make.

Mr. RYAN. Thank you, Mr. Chairman.

I also want to extend a warm welcome to our new CBO director, Doug Elmendorf.

And I also want to say to Bob Sunshine, thank you for your service. You did a fantastic job extending the objectivity and integrity of the Congressional Budget Office during your tenure. So thank you, Bob.

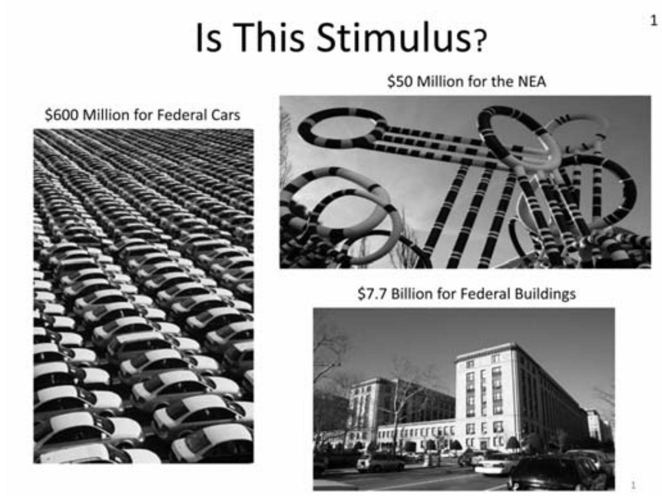
The need for today's hearing is obvious. Job losses are mounting each day, and we get fresh evidence of the fact that we are in the midst of a near economic downturn. Just yesterday Caterpillar announced they are laying off 20,000 workers this year.

Clearly, Congress must take action to address this situation. The hard part is deciding what we should do. The House will consider this week an $816 billion economic stimulus legislation advertised as a focus plan to get the economy back on track and create jobs.

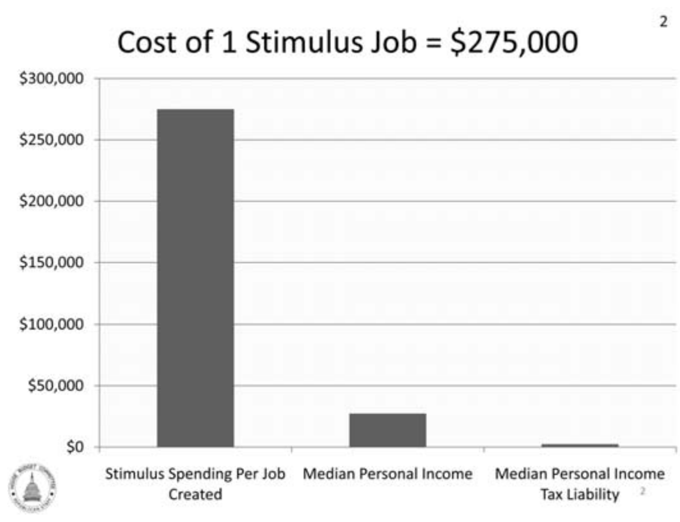
But upon closer examination, it looks more like a sprawling, bloated spending bill that comes with a huge price tag with little evidence it will actually have any immediate impact on our economy.

Please go to chart number 1. Under the guise of stimulus, this bill includes funding to buy cars for Federal employees, renovate

Federal buildings and bulk up the National Endowment of the Arts.



Please go to chart number 2. Even if it produces the 3 million jobs that are being claimed by the administration, it will cost $275,000 per job. Compare that to the average income of an American or the tax bill that he or she will pay. They are the ones that will ultimately foot this bill.



According to CBO's data, it will have little impact in the short run, with only 15 percent of the spending occurring this year.

Congress should be focusing its efforts on proven, fast-acting methods for sparking job creation. And frankly, I am not at all encouraged by the track record of these Keynesian fiscal stimulus plans. The advertised benefits of government spending simply fail to play out in reality. The most direct and cost-effective way to get the economy back on track quickly is to boost tax incentives for private businesses to expand and create more jobs. Private capital in investment, not government borrowing and spending, is the key to restarting the engine of sustainable job growth in this country.

That is why I am disappointed to see that less than 3 percent of the current economic stimulus package is specifically aimed at encouraging private sector investment through tax incentives.

There is a great deal of fear and uncertainty in the markets right now. A lot of private capital is on the side lines, and many business investment plans are frozen. This is not only due to the uncertain economic environment but also to the highly uncertain tax policy environment. And this is something Congress can and should address. Big tax hikes on work, savings, and investment are now less than 2 years away.

At the end of next year, when these tax increases are slated to come on line, CBO tells us that the unemployment rate will be at 8.5 percent, which would be the highest jobless rate in more than 25 years. The huge spending in this package will inevitably lead to cause for even more tax increases. Allowing job-killing tax hikes to hit a still weak economy would be sheer folly.

If we want to help this economy, we can start right now by giving workers, investors in businesses the certainty that Congress will not raise their taxes during this period of economic weakness. Our short-term reaction to the current economic crisis must not cloud the proven long-term economic strategies that should guide our recovery and help secure our renewed prosperity. Instead of the big government borrow, spend and consume approach of this bill, we should pursue incentives to put private sector capital to work to create permanent growth and job creation.

I hope we can learn more today about the effectiveness of this bill to address our economy. And I look forward to the witnesses' testimonies, and I yield back the balance of my time.

Chairman SPRATT. Thank you, Mr. Ryan.

Before getting underway, just a couple of housing keeping details.

First of all, I ask unanimous consent that all members be allowed to submit an opening statement for the record at this point.

Without objection, so ordered.

We welcome before the committee our distinguished new director of the CBO, Dr. Douglas Elmendorf.

I already had the opportunity to read your testimony last night. There is a lot of good stuff there. All of your testimony and all of the witnesses' testimony which has been filed will be made part of the record. You can summarize as you see fit, but I encourage you to take your time and walk us through it because there is a lot of very substantive information and material and analysis in your testimony.

The floor is yours, sir.

STATEMENT OF DOUGLAS ELMENDORF, PH.D., DIRECTOR, THE CONGRESSIONAL BUDGET OFFICE

Mr. ELMENDORF. Thank you, Chairman Spratt, Ranking Member Ryan, and members of the committee.

I am very pleased to be here today to talk with you about the state of the U.S. economy and policy options for improving it. I am especially happy to be here today in my first testimony as director of the Congressional Budget Office.

I would like to make just three points drawing from the written testimony. First, in the absence of any changes in fiscal policy, the U.S. economy is likely facing its most severe downturn since the Depression of the 1930s.

Second, the bleakness of the economic and financial outlook has lead the great majority of economists to think that both large-scale fiscal stimulus and significant new monetary and financial policies are appropriate and needed to generate a strong recovery in the next few years.

Third, in CBO's estimation, the American Recovery and Reinvestment Act of 2009, H.R. 1, would provide a significant boost to output and employment.

Let me elaborate on these points in turn. First, CBO projected in early January that in the absence of changes in fiscal policy economic activity will contract more sharply in 2009 than it did in 2008 and will expand only moderately in 2010. As a result, the shortfall in the Nation's output relative to its potential, what could be made if we were using all of our resources fully, will be the largest shortfall in terms of both length and depth since the Depression. Lost output will represent nearly 7 percent of potential output in both 2009 and 2010, amounting to about $1 trillion of lost output each year and would be almost 5 percent of potential output in 2011.

Payroll employment declined by 2 and a half million jobs last year. And CBO projects that, again, without further action, even more jobs will be lost this year. The unemployment rate increased by more man 2 percentage points last year, reaching 7 and a quarter percent and is projected to peak above 9 percent next year.

Data released after this forecast was finalized in mid-December have been generally consistent with our forecast. In the financial system, recent data signaled that the improvement in conditions that began in October have continued thus far this winter.

Still, for many borrowers credit remains much more difficult and expensive to obtain today than it was in 2007. Risk spreads on most types of private lending remain very elevated. And concern about the health of financial institution remains widespread.

Meanwhile, data on the wider economy confirm the consensus assessment that the economy is in sharp decline. The economy shed more than half a million jobs last month. The unemployment rate jumped up. Industrial production, our manufacturing output essentially, fell 2 percent in December, and capacity utilization and manufacturing reached its lowest level since 1983. Housing construction continues to drop sharply, and real business spending on equipment and software appears to have fallen at more than a 20 percent annual rate in the fourth quarter.

My second point is that the expected severity and persistence of economic weakness have lead the great majority of economists to think that both fiscal stimulus and additional financial monetary policies are needed at this time. As the CBO has said before, fiscal stimulus policies are most effective if they are timely, occurring during the period of economic weakness; are cost-effective, providing the greatest possible economic impact per dollar of budgetary cost; and do not exacerbate the Nation's long-run fiscal imbalance.

Moreover, the macroeconomic impact of stimulus is not the only consideration in designing it. Policymakers and members of the public clearly care also about who will be helped directly by the spending increases or tax cuts in addition to all of the people who will be helped indirectly through a stronger economy. And they care about what goods and services society will receive in exchange for the money involved.

Constructing a stimulus package that both is effective in spurring economic activity and satisfies broader objectives about who benefits and what society receives in exchange is very challenging.

Third, H.R. 1 is a massive fiscal stimulus. According to estimates by the CBO and Joint Committee on Taxation, the legislation would widen the Federal budget deficit by $170 billion this fiscal year; $356 billion in fiscal year 2010; $174 billion in fiscal year 2011; and a total of $816 billion between now and 2019. Details of this cost estimate were released last night and are on the CBO Web site, and I am happy to talk about them if you have questions.

The bill includes direct payments to individuals, reductions in Federal taxes and purchases of goods and services directly by the Federal Government and indirectly via grants to State and local governments.

For the payments to individuals and reductions in Federal taxes, the macroeconomic impact would occur fairly rapidly.

For purchases of goods and services, CBO has estimated fairly slow initial rates of spending. Of course, these estimates may turn out to be too low or too high. But here is why they are as low as they are:

First, the usual process for drafting plans, soliciting bids and entering into contracts, makes typical spending rates, the ones we see year in and year out, much slower than one might think.

Second, enactment of this legislation would occur nearly halfway through fiscal year 2009. The numbers that we report for what may appear to be the first year are actually for the first half-year.

Third, a number of programs in this legislation would receive funding significantly above their current allocations. In the past, in all types of Federal programs, a noticeable lag has occurred between sharp increases in budget outlays, budget authority, and the resulting increase in outlays.

Fourth, some programs would be essentially brand new. In this case, agencies would need to develop procedures and criteria, issue regulations, and review plans and proposals before money can be distributed.

All that said, CBO estimates that roughly 21 percent of the total budgetary amount would go out in the next half of fiscal year 2009 and nearly half next year, for a total over the next year and a half of roughly two-thirds.

The macroeconomic impacts of any economic stimulus program are very uncertain. CBO has developed a range of the estimates of the effects of H.R. 1 on GDP and unemployment that encompasses a majority of economists' views in our judgment. According to this analysis, the legislation would have the following effects relative to our baseline forecast:

In the fourth quarter of 2010, GDP would be higher by 1.2 to 3.5 percent. Employment would be higher by 1.2 to 3.6 million jobs. And the unemployment rate would be lower by .6 to 1.9 percentage points.

In the fourth quarter of 2011, the positive effects in output and employment would be smaller but still significant because the spending out of authorized money will be going on and because the tax changes and some of the mandatory spending changes will still be in effect.

Thank you, that concludes my prepared comments, and I am happy to take any questions that you have.

[The prepared statement of Mr. Elmendorf may be obtained at the following CBO Internet address:]

http://www.cbo.gov/ftpdocs/99xx/doc9967/01-27-StateofEconomy—Testimony.pdf

Chairman SPRATT. Dr. Elmendorf, you have on your testimony figure one, do you have an electronic copy of that?

Mr. ELMENDORF. I do not have it with me, no, sir. I have a copy I can look at, but I don't have one that I can——

Chairman SPRATT. Let me just repeat the numbers you have in your testimony. To measure the worth and value and effectiveness of the stimulus program that is now being packaged and put together to be brought to the floor tomorrow, one critical way to look at it is what is potential GDP if the economy were running more or less on even keel, and what is actual GDP?

Could you sort of translate this chart to us here? What is the difference today between the gap, performance gap, between actual GDP and potential GDP if the economy were running in a stable condition?

Mr. ELMENDORF. The potential GDP is a concept economists use to estimate the output the economy would produce if labor and capital resources were essentially fully employed. So when the unemployment rate rises or capacity utilization falls, output, actual output, is falling below potential output. CBO's estimate is that without any additional fiscal policy, that shortfall, the difference between what we could be producing and what we will be producing will be nearly a trillion dollars in 2009 and again in 2010.

Chairman SPRATT. Each year, a trillion dollars?

Mr. ELMENDORF. Each year, and will remain very large in 2011. It is worth emphasizing here that people talk about the dates of a recession. The way that the National Bureau of Economic Research traditionally defines "recessions" is the period in which the output of the economy is falling. So if output turns back up next year some time, the NBER would consider that to be the end of the recession. But the shortfall in output from the potential output level will still be quite large. We are making a big gap, and when we turn the economy back around again, it will take a considerable amount of time before actual output rises back to potential output, before the unemployment rate falls back down to a more standard rate of unemployment. We have seen that coming out of the last two recessions, much milder recessions than we are enduring now, but nonetheless it has taken some time after the official end of the recovery for the unemployment rate to fall back down again.

And the principal way to think about that is the actual output may be rising, but it is still well below the level of potential. And until it catches up again, we will not see unemployment back down to its traditional level, and we will not see employment back up to what it should be.

Chairman SPRATT. And potential GDP is not optimum GDP; it is a reasonable expectation at a normal——

Mr. ELMENDORF. Yes. It does not assume completely full employment. In CBO's case, it assumes an unemployment rate of about 4 and three-quarters percent, which seems consistent with—I think 4 and three-quarters percent, which seems consistent with what we observed in the past as the lowest sustainable rate of unemployment.

Chairman SPRATT. Now, looking at the value of the return over time, the benefit stream that accrues from the plan, is it proper to look at the flow over time more than 1 year, not just next year and the following year, but if it is education, for example, or if it is infrastructure, it has some lasting economic productivity improvement?

Mr. ELMENDORF. Yes, so there are really two issues there. The first thing is to say, because this GDP gap will persist for a number of years, fiscal stimulus to try to narrow that gap would be appropriate in the minds of a wide majority of economists for a number of years, not just in 2009 and 2010.

A broader point I think you are making, Mr. Chairman, is that investments that are made in the economy today will reap benefits potentially for many years to come. And those investments can be in the form of physical capital, highways, broadband, water supplies, or it can be in the form of what economists call human capital, which are the education and skills of the workforce.

Chairman SPRATT. Now, towards the end of your testimony, you say all of these things need to be taken into account, including the long-term impact of having substantial deficits. And you warn against the accumulation of substantial deficits beyond the immediate situation. Could you elaborate on that just a bit, because I think it is very worthwhile testimony.

Mr. ELMENDORF. Yes, as you know, the long-run fiscal imbalance of this country under current policies is quite severe. If that imbalance is worsened, that has a number of consequences. One consequence is that, over time, that government borrowing crowds out a certain amount of private investment and leaves the economy poorer as a result.

A further possible problem is that anticipation of government borrowing can push up interest rates. At the moment, interest rates in the United States on risk-free assets like Treasury securities are fairly low because foreign capital views us, despite all of our current problems, as a relatively safe haven in the world. So interest rates are low because foreign capital has come to this country.

If we make the long-run fiscal situation worse in the eyes of people, investors around the world, and they are more worried about our long-run future and withdraw some of those funds or stop sending additional funds here, then that could push up interest rates in the near term and have a detrimental effect on economic activity now.

I do not think, and most economists do not think, that is a very large risk at the moment because of the flight to safety that we see in times of crisis. But I think most economists would judge that to be an increasing risk as we come out of this recession in several years. If there isn't a sense at that point that the long-run fiscal problems are being addressed, there is a bigger risk at that point of more fear and then an increase in U.S. interest rates.

Chairman SPRATT. So the request before us is how to boost the economy, pick it up out of the current slump, get it back on track, but without worsening the long-term outlook for the budget and, in particular, the deficit and debt accumulation.

Mr. ELMENDORF. That is right. And that, as I said in the testimony, is a challenging task.

Chairman SPRATT. We have had recessions in the past. I guess 10 recessions since the Second World War. Few have elicited the kind of response we are seeing today. Is this disproportionate? Are we overreacting? Or would we be risking some serious downturn and loss of control of situation unless we acted?

Mr. ELMENDORF. I think you are absolutely right. We have not seen fiscal stimulus on this scale proposed in these past downturns. There are two reasons why most economists thought that made sense then, but this makes sense now. One is that this downturn looks to be more severe. The collapse of leading financial institutions, the flight from risk-taking has choked off credit that would normally flow to households and businesses. Tremendous losses in household wealth are holding down consumer spending and will do so for some time.

Our overbuilding of housing in the past half dozen years means that, even at the low level of construction now, we have more houses than people want, and it will take some time to work that off. So housing will not provide support in the recovery.

And moreover, the global economy is weakening. Forecasts of foreign economic growth in 2009 have been marked down by two percentage points just since last summer. So there are a number of reasons why this recession will be particularly deep in most economists' judgment and why the recovery will be slow in most economists' judgment. The second general reason why most economists favor larger fiscal stimulus now than they have in past recessions is that monetary policy has done a lot already to try to offset the weakness in the financial system and has used up all of its principal tool, which is reductions in the Federal funds rate, since that rate is now essentially at zero. It does not mean they are out of tools. As Chairman Bernanke has said very clearly, they have other tools, but these are untested tools, and they face difficulty in implementation.

So economists see a more severe recession than we have had in the past and less ability of the Federal Reserve to offset that. And that has lead many people who did not support large fiscal stimulus even a year ago to support it today.

There is uncertainty, of course, about these forecasts. CBO aims to have an economic forecast and budget projections for that matter for which the risks of the world turning out to be better or worse are approximately balanced. But most economists think that now the risk should not be viewed as balanced in a policy sense because of the limitations on what the Federal Reserve can do.

If the economy were to boom again, the Federal Reserve could pull back on its special lending programs and it could raise the Federal funds rate. If the economy were to turn out much weaker than we expect, that would put even more pressure on a Fed that, as I said, is already operating on very unfamiliar terrain. That uncertainty and taking some insurance against that uncertainty is a further reason that economists, I think, on a widespread basis support large-scale fiscal stimulus now.

Chairman SPRATT. One final wrap-up question. In the past recessions since the Second World War, we typically had certain sectors that lead us in and lead us out of recession, automotives, real estate, consumer expenditures. Today automotives clearly are not going to lead us out of this recession in their current condition. Real estate is overhanging the market, and it is not going to lead us out of a recession. As far as consumer expenditures are concerned, there is a huge wealth effect, negative wealth effect, due to the decline in real estate values, which is a principal asset that households have, and businesses aren't likely to invest in this kind of scenario, at least not in the near term. What else, other than our intervention, would begin to give us a kick start to get out of this slump and back on the road to recovery?

Mr. ELMENDORF. I think you summarized the headwinds very aptly, Mr. Chairman.

And that is exactly why economists believe that some combination of additional government demand for goods and services and additional private demands spurred by tax reductions are necessary at this time to put the economy back on a path to recovery.

Chairman SPRATT. Thank you very much, sir.

Mr. ELMENDORF. Thank you.

Chairman SPRATT. Mr. Ryan.

Mr. RYAN. Thank you, Chairman.

Dr. Elmendorf, the last time we had an administration that believed fiscal spending stimulus was the way to go coming into an economic downturn was in 1993 when the unemployment rate was 7.3 percent and the Clinton administration then was asking for a $16 billion stimulus. Now, clearly, the economy is in worse trouble today than it was then. Even though our unemployment rate is not quite as high as it was at that specific time, we believe it will get higher.

So the advocates of this particular stimulus bill say that the goal here is to get the money out the door as fast as possible. Let me ask you about that. According to your analysis, how much of the spending in this bill, not the tax cuts but the spending in this bill, which actually get spent in year 1 and in year 2?

Mr. ELMENDORF. According to our estimates on both appropriations spending and the mandatory spending, 15 percent of the spending would happen in the remainder of fiscal year 2009, essentially the next 7 months.

Mr. RYAN. Next two quarters.

Mr. ELMENDORF. And then 37 percent would occur in the four quarters of fiscal year 2010, for a total over the next six quarters, not quite the same thing as 2 years, over the next six quarters of 52 percent.

Mr. RYAN. So half of it is outside of the next six quarters?

Mr. ELMENDORF. Right.

Mr. RYAN. The administration's budget director, your predecessor, contends at least 75 percent of the spending in the bill will occur in the next year and a half. Now, CBO, we pride ourselves here that CBO provides independent objective analysis, but how do you account for the sizable disparity between your estimates of spend-outs and the OMB's estimates?

Mr. ELMENDORF. So the first thing, as I recall, what Peter Orzag said it was 75 percent of the total dollars from the package——

Mr. RYAN. So he was talking, he was throwing, including the stimulus in with the spending——

Mr. ELMENDORF. So I believe that the comparable number from our estimates is 65 percent.

Mr. RYAN. So when you add the tax side of it, that moves faster than the spending side of it, correct?

Mr. ELMENDORF. Correct.

Mr. RYAN. So tax policy, as a rule of thumb here, is faster deployed in the immediate term than spending policy.

Mr. ELMENDORF. That is right, I think, in general. It depends of course on the specific provisions. But, in general, for this legislation, the tax provisions pay out faster than the spending provisions.

Now, recall, though, that when I listed the criteria for effective fiscal stimulus, timely was one of the criteria, and the second one cost-effectiveness. And CBO judges and most economists judge that a dollar of government outlay has a larger effect on GDP than a dollar of tax cut for the simple reason that the dollar of extra government spending goes directly to demand for goods and services, whereas a dollar of tax cut will be partly saved by households in general and partly spent. Now depending on just what provisions are changed, one can obtain different answers.

Mr. RYAN. There is a lot of great research from academics around the spectrum on multiplier effects. It is clearly, you know, we are not settled on that debate. I won't belabor that.

Let me ask you about assuming that this $816 billion package is financed through borrowing, which obviously it will have to be, what is CBO's estimate of the interest impact of this bill over the next 10 years.

Mr. ELMENDORF. As it turns out, I believe I have that number here.

Mr. RYAN. We have been asking for it.

Mr. ELMENDORF. So I think this letter, if I can actually find it, yes, I think that you should be this morning in receipt of our estimate of that. So we did a calculation, at the request of Congressman Ryan, about the cost of additional debt service that would result from enacting H.R. 1 under our current economic assumptions and assuming that none of direct budgetary effects of H.R. 1 are offset by future legislation. Under those assumptions, we estimate that the government's interest cost would increase by about a billion dollars in this fiscal year and the total of roughly $350 billion over the next 11 years, 2009 to 2019.

Mr. RYAN. Three hundred and fifty? Three-five-zero?

Mr. ELMENDORF. Yes, $347 billion.

Mr. RYAN. So we are in excess of a trillion dollar package here when you count the additional costs.

Mr. ELMENDORF. Traditionally the way CBO talks about the effects of spending provisions, the way the Joint Committee on Taxation talks about the effects of tax provisions, we talk about the effect on non-interest spending and revenues. And the reason for that, I think, is simply that what happens to the interest costs depends on future policies that we are not entitled to speculate about. So we report the direct effects of this legislation.

Mr. RYAN. So we are talking about a $1.2 trillion total cost when we count the interest into it.

Mr. ELMENDORF. If you add up our estimate of interest cost over the next 11 years with the estimate of the legislation, which we put at $800 billion roughly, then you get your number.

Mr. RYAN. Thank you.

One other question, because I don't want to belabor this stuff. We have all these other governments who are considering the same kind of thing. I guess it is 1936 all over again, and we are all Keynesians now. So Europe is taking about a big fiscal stimulus along these lines. You name the country, most of the industrialized world, China included, is talking about a large fiscal stimulus which must be financed by borrowing.

So many of the world's nations are going to be going into the credit markets at the same time. We are all going to go into the credit markets with our bonds and try to finance this. What in your opinion is going to be the effect on the yield curves, on the price of borrowing, and how will that impact the overall global economy?

Mr. ELMENDORF. Most economists will tell you now that it is advantageous to the global economy for significant fiscal policy expansions around the world. You raise an important question about where the funds will come from. I think the answer to that question is that consumers and businesses are pulling back in their spending. The essence of fiscal stimulus is to provide demand for goods and services that private households and businesses are not providing at this moment. So the extra saving that they are doing will essentially provide the funds for the borrowing the governments will be doing.

And the problem arises, as I mentioned earlier, several years down the road if household and business spending is back up again and conditions in credit markets, there are less funds available, and if all of the governments around the world have set themselves on permanent higher borrowing trajectories, then I think that problem becomes more acute.

Mr. RYAN. In a number of months you are going to have to give us another deficit projection. Your current deficit projection is $1.2 trillion, but that is minus all the other things we are going to pass just in a matter of weeks here. You have this stimulus plan with your spend-out rates. You have got an omnibus spending bill that is going to pass in a week or two. You have got the supplemental spending, which I think is something like $25 billion we are projecting. Adding up what Congress is going to pass over the next few months, stimulus, omnibus, supplemental, what is the deficit going to look like this year, later this year?

Mr. ELMENDORF. I have not done that calculation, but, clearly, when you start at $1.2 trillion, if you add the effects of this legislation under consideration now and other things you have discussed, the numbers get very, very large.

Mr. RYAN. What kind of ball park do you think?

Mr. ELMENDORF. I think if you take this legislation and add it to the baseline, instead of being at $1.2 trillion, you are at $1.4 trillion. The $1.2 trillion alone is more than 8 percent of GDP. I think it is entirely possible that when you finish this year, the deficit will be 10 percent of GDP. That is an absolutely stunning figure.

But it is also stunning that I sat here and reported our forecast and we believe the consensus of forecasts that, without fiscal action, we are entering the most severe downturn in the lifetime of anybody in this room. And I think the judgment of most economists is that very unusual circumstances call for very unusual actions.

Mr. RYAN. I think we would agree; we may just not agree on how best to achieve it. Thank you.

Chairman SPRATT. Ms Schwartz.

Ms. SCHWARTZ. I thank you, Mr. Chairman. And I thank you for the first hearing of the committee, so we look forward to an interesting and maybe challenging year before us.

Dr. Elmendorf, given what you have said and what we have just heard, first, let me just maybe reiterate something that we all know, but maybe we keep needing to be reminded of, we are in a dramatically severe economic downturn. I think almost every economist, as you point out, says we need strong, bold, clear action. And I will say, what we are trying to do here is to really take I think some of what you said, and I wanted to have you elaborate on this, is that the answer here is not any one single action, which makes maybe the recovery and reinvestment bill that we are going to have before us to be more complicated than some people might like.

The Republican side has suggested that there is too much spending; we call it investment in both Americans and American businesses. They prefer spending as much money, if not actually more, but only in one direction, which is tax cuts for the wealthy and tax cuts for businesses. I think I would like you to speak to that as to whether that is actually, if we take just that action, more tax cuts alone, $4 trillion is what they are suggesting, which is far more than what we are suggesting in this stimulus and the recovery plan, whether that single action—actually, we have been doing that for 8 years—whether that would actually turn this economy around.

Instead, I think what we are trying to do, and I want your response to this, is to really take what is a substantial sum of money—all of us are certainly well aware of $825 billion is a serious, significant investment. But we are trying to do three things. One is to relieve the burden on working families that have been hard hit by this economic downturn. We are talking about 95 percent of Americans getting an individual tax cut, not a one-time rebate but an ongoing tax cut, that hopefully will restore their confidence going forward; not a one-time spending spree one week but actually on ongoing confidence, education tax credit, the COBRA provisions in helping families.

And secondly, we are trying to stem the job loss. You heard the numbers. Yesterday we lost 65,000 jobs in one day. It is stunning. We have to stem the job loss and begin to rebuild and stimulate the economy to create jobs. We are doing that through infrastructure spending. Business tax cuts are certainly an important part of this package and investments in new technologies, like green energy.

And the third area is that we are looking to really promote the kind of investments that will create new jobs for the future, health IT, information technology, energy efficiencies.

My question to you is, the balance between those three really targeted ways of spending taxpayer dollars to stimulate the economy to deal with the really tough situation that Americans are in and to grow jobs for the future, my question is, have we gotten the balance right in those three areas? And do we need to spend all those dollars in 1 year, but don't we need to actually build the confidence, as the chairman said, over time to get investor and consumer confidence back up? But, specifically, could you speak to the balance between these three areas, tax cuts, serious investments and helping Americans deal with a tough economy?

Mr. ELMENDORF. So, naturally, I can't tell you whether you have got that balance right. That is a judgment you all will have to make.

Economists, as I said, are merely united in their conviction that further fiscal policy actions are appropriate. But they are much more divided about which actions, what sorts of actions, should receive the greatest attention.

I think there are a number of reasons why you might choose a combination of strategies. One is that different policies have effects on a different time frame. The tax policies and mandatory spending programs pay out faster, in our estimation. The appropriations pay out more slowly. That doesn't mean in fact that they are less useful. As I said at the beginning of my testimony, we expect to have a very large shortfall in output relative to potential in 2011. You don't really want to have a policy that provides a lot of stimulus in 2010 and then goes away overnight; that risks dropping the economy back into a pothole.

So in an effort to have stimulus that affects the economy now and next year and in 2011, you might find a collection of policies that spend out at different rates to be appropriate.

I think a second reason a combination of policies makes sense is that there is a lot of uncertainty around the effects of every provision. We have made our best estimate drawing on the wisdom of the profession, but to be clear, we don't have any historical examples of this sort of condition and this magnitude of fiscal stimulus. So any estimate that we offer you will be very uncertain. And that is why I presented our numbers as a very wide range. So the uncertainty is also a reason why you might favor a combination.

I think a third reason, as I said, is that there are different sorts of goods and services that are produced depending on what legislation you pass. Legislation that only cuts taxes will lead indirectly to the production of a lot of household demanded goods and services. Legislation that supports health insurance will lead to more health care being delivered. Legislation that supports highway building or water supply renovation will lead to better highways. So, ultimately, there will also be, in addition to the macroeconomic stimulus issues, there will be a value judgment about what sorts of products society should be focused on.

Ms. SCHWARTZ. But the concept of doing a combination, doing a variety, and stimulating growth in a variety of sectors rather than just picking one area is something you think will benefit all of us.

The chairman wants us to move on.

Mr. ELMENDORF. I think that makes sense for the timing reasons and the uncertainty and the question of priorities.

Chairman SPRATT. Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman.

Dr. Elmendorf, in your testimony I believe you said that CBO looked to the timing of the stimulus legislation, cost-effectiveness, and that it be consistent with long-term fiscal objectives. With respect to being cost-effective, we have now learned that, I think what was billed as an $816 billion stimulus package, if you add in the debt service, is really over a trillion dollars.

But before we add in the debt service, which of course does have to be paid, the proponents of this particular package I believe have talked in terms of roughly three and a half million jobs. And as the ranking member put up a chart, I believe that if those figures are accurate, and since they come from the proponents, I would assume they would be somewhat in the mode of a rosy scenario, it comes up to $275,000 per job. What is the definition of cost-effective by CBO standards?

Mr. ELMENDORF. I think we need to be careful in counting jobs. I think this has been an unfortunate drift in the public debate toward number of jobs measured at some particular point in time. What I think we all care about is the flow of jobs over time. If we can devise a stimulus package that would put a ton of money out there in the next 6 months, we might find a big increase in employment relative to what otherwise would occur. When the package ended, unemployment would fall right back again. So when we talk about jobs, we have to be careful not to pick out a particular year or quarter, but to look at the flow over the next set of years that are affected by legislation.

Mr. HENSARLING. Dr. Elmendorf, has CBO modeled how many jobs they expect to be created under this package?

Mr. ELMENDORF. Yes, and we have——

Mr. HENSARLING. How does that differ from the administration's figures?

Mr. ELMENDORF. Let me describe ours first. Our estimate is that it costs about $140,000 worth of GDP to get an additional job. How you get that much GDP, how much government spending or tax cuts you need, depends on the multiplier effects. So you take some amount of government extra spending or tax cuts, apply a multiplier effect on GDP, and then from that you can deduce effect on employment.

Our estimates are about $140,000 per job next year. I think that is quite consistent, as best I can tell, with the estimates with the cost per job of the estimates given by Christie Romer and Jared Bernstein from the administration, given by some private forecasts.

I think the difference in the forecasts——

Mr. HENSARLING. That doesn't answer the question, Dr. Elmendorf, and unfortunately, my time is running out.

Also in your testimony, again, you talked about a package being consistent with our long-term fiscal objectives. We have known that, over the last 2 years, the Federal deficit has gone from roughly $160 billion to $1.2 trillion, I believe, in rough figures, an increase of roughly 800 percent. That is before we add on the cost of this particular package, which we now know is over a trillion dollars. I assume that you have looked at the experience of Japan in the early 1990s, their lost decade. They attempted 10 different stimulus packages over 8 years; their GDP did not increase. And I believe they took on the highest per capita debt in the industrialized world, and their per capita income went from second in the world to tenth in the world. What can we learn from their experience?

Mr. ELMENDORF. I think the principal lesson of the Japanese experience, and I will be talking about this tomorrow in testimony before the Senate Budget Committee, is that active financial and monetary policies are a critically important compliment to fiscal stimulus. And that is not an idiosyncratic view of the CBO. I think that is a widely held view; one that, as I mentioned here, that we need a combination in most economists' judgment of fiscal stimulus and monetary, financial policies.

I think the principal view looking back at the Japanese experience is that they flubbed the financial rescue. Basically they didn't face up to the extent of the problem. They ended up papering over the problem in a way that just festered.

Mr. HENSARLING. Dr. Elmendorf, how about our own lesson, and you are speaking of monetary policy, but if we as policy makers don't get it right—I don't think there is any debate that we need a stimulus package. There is a debate on whether or not we should be providing tax relief to families and small businesses or growing government. But can a case not be made that we sowed the seeds for this recession by public policy decisions in the last one, particularly monetary policy, in creating the easy money that allowed the housing bubble to occur?

Mr. ELMENDORF. In the judgment of most economists, the principal policy error regarding the housing and financial bubble was on the regulatory side.

There is some disagreement about when the Federal Reserve should have stuck to a higher interest rate policy. If they kept interest rates much higher, that would in fact have choked off the housing and financial bubble, but it also would have choked off an awful lot of jobs during that period. The unemployment rate at the time the Federal Reserve pushed the Fed Funds rate so low was a very high unemployment rate. So I think there is disagreement among economists about whether they should have taken that medicine then or not.

I think it is a more widespread view that our regulatory policies needed to be stronger.

Chairman SPRATT. Mr. Doggett.

Mr. DOGGETT. Yes, sir. Thank you, Mr. Chairman.

And, Dr. Elmendorf, thank you for your service. I know that your first report here concerning the effectiveness of this stimulus has stirred some controversy. And I think that it is important that we continue to get straight-on, independent objective reports from you. It is important they be complete, but I appreciate the analysis that you provided.

Of course, if you make any exception to that, and it is my bill, it is okay to give the benefit of the doubt to the author, and I am sure all the other members here feel the same way.

Seriously, as it relates to this economic recovery package, I think, given the size of the debt service you are talking about, that is important, and I believe these are more or less the words of Dr. Zandi, who we will hear from later, that we try to get the biggest bang for the buck, the most cost-effective stimulus because we have, even though it seems, and it is, a very big package, we need to be getting the most economic growth we can for every dollar we put in.

Now both you and Dr. Zandi have done some analysis in your testimony of what type of initiatives provide us the biggest bang for the buck. And just to summarize that, and of course, we had this testimony a little over a year ago when some of the same folks who are complaining about this package were complaining about our doing anything, in December of 2006, excuse me, December of 2007, running right on through last summer. But isn't the economic opinion pretty well united that at the top of the list of the biggest bang for the buck is to use extended unemployment benefits and food stamp benefits?

Mr. ELMENDORF. Yes. I think most economists view expanded benefits for low-income households as a particularly effective form of fiscal stimulus, because the money generally flows quickly and generally a high share of it is spent, so it satisfies both the timely and cost-effectiveness criteria.

Mr. DOGGETT. With a package this big, you will have some elements that are more cost-effective than others. Clearly, with a package this big, you couldn't put it all in those two.

But I believe Dr. Zandi's testimony indicates that, for every dollar that we spend on expanded unemployment benefits, we get $1.63 back in gross domestic product. For every dollar we spend on food stamps, we get back $1.73. Are figures in that range generally where economists come down?

Mr. ELMENDORF. I think——

Mr. DOGGETT. Maybe not to the penny.

Mr. ELMENDORF. Yes, I don't want to speak that precise, and Mark, of course, can talk about them. But I think most economists view those categories as having particularly high multipliers.

Mr. DOGGETT. On the other hand, you and Dr. Zandi have both, in your testimony, described some of the least effective ways, the most wasteful and inefficient, weak ways of stimulating gross domestic product. And at the top of that list, it looks like, though your estimates are somewhat varied, the least effective, most inefficient, most wasteful way of doing this is the loss carryback provisions, in other words, corporate tax breaks to let those who paid a little bit of taxes in prior years now get a check back from the government or credit back from the government at a time that they have a loss. Is that right?

Mr. ELMENDORF. We conclude that the multiplier of that, the effect on the economy of changes in the tax loss carryback are likely to be small. But I would emphasize, I think that judgment is particularly uncertain. In normal times, providing additional cash flow to businesses is not as effective a way of stimulating investment as a particular investment incentive.

But we are not in normal times. Companies are having—are facing cash flow problems, of course, because of the recession and they are having difficulty borrowing. So that is a type of stimulus that we think is not likely to have big effects but where much bigger effects really are possible.

Mr. DOGGETT. It may be that, for political reasons, just like we could not get support from the last administration, which was addicted to tax cuts as the only solution to every problem, no matter the economic weather, and so we went there instead of providing the much more effective extension of unemployment benefits that was really needed early last year, that we have to include ineffective, wasteful efforts.

But I notice, for example, that Dr. Zandi, in contrast with getting $1.73 of Gross Domestic Product for every dollar, precious dollar that we take out of the Treasury for food stamps, his estimate is that on this loss carryback provision, this wasteful provision, we get a total of $0.19, only $0.19 for every dollar taken out of the Treasury. Without asking you to be committed to whether it is 19 or 20 or 30 or 40, it is substantially less in terms of its economic benefit than doing some of the other things that are in the stimulus package; and there is consensus among a broad stream of economists that it is substantially less.

Mr. ELMENDORF. Our assessment is that it is likely to be substantially less. I think it is an area where consensus is harder to come by because of the uncertainties.

Mr. DOGGETT. And he also estimates that a permanent cut in corporate taxes would only give us $0.30 for every dollar, in contrast with the higher amounts.

Mr. ELMENDORF. I think you will need to ask him that question. That is not part of this legislation, and we didn't speak to it in our report.

Mr. DOGGETT. Thank you, Mr. Chairman.

Chairman SPRATT. Mr. Campbell.

Mr. CAMPBELL. Thank you, Mr. Chairman; and thank you, Dr. Elmendorf.

If we do nothing and if there is no economic stimulus package, at what point, under your models, would the economy bottom and/or begin to recover; in other words, positive GDP growth?

Mr. ELMENDORF. We think that the unemployment rate will peak early next year. That means that—and unemployment tends to lag the economy, so we are looking at GDP that would bottom later at the end, perhaps, of this year.

Mr. CAMPBELL. And perhaps the first quarter of 2010, again, if we do nothing, would have positive—would have some growth, even if it is a tenth of a percent?

Mr. ELMENDORF. Yes. That seems likely.

Mr. CAMPBELL. Okay. So under that scenario then—and I can't remember the exact percentages—but something like 75 percent of the spending stimulus in this bill will occur after a recovery has already occurred, even if we did nothing. And I guess my question is, isn't the purpose of these things supposed to try and make the recession shorter and shallower, and how can it do that if the spending comes after the recovery?

Mr. ELMENDORF. I think I need to emphasize here, again, the importance of the gap between potential output and actual output. When the economy turns back up, under our forecast, late this year or early next year, the difference, the shortfall in output relative to what the economy could produce at a more traditional unemployment rate and traditional rates of capacity utilization will be about $1 trillion. And because we expect the recovery to be slow, GDP growth actually to be, although growing, to not even be growing as rapidly as the labor force is for a while, that gap remains very large throughout 2010 and is larger in 2011 than it has been in almost all of the postwar years. So, again, whether the technical definition of recession has been passed, there will still be, I think, tremendous waste of resources, tremendous unhappiness.

Mr. CAMPBELL. In the interest of time, we will have to hold out.

Another question. There was—in 2007, 2008, last year, there was an economic stimulus plan that involved refundable rebates to taxpayers with some spending, obviously a small amount of spending, but that doesn't seem too dissimilar from the refundable rebates that are in this bill. I believe—and correct me if I am wrong—but there is kind of universal agreement that that stimulus was not effective in 2008. Why would doing the same thing be effective in 2009?

Mr. ELMENDORF. I think, in fact, that the economists who study this question are less sure that last year's rebate was ineffective than one might think from reading the coverage in newspapers. Clearly, we have a recession anyway, so it was not effective in stopping the recession. But I think that is more a reflection, in most people's view, of the scale of the financial carnage and not something that speaks specifically to that tax provision.

People who have looked very carefully at the household level spending data conclude that there was a real spending effect of that rebate. Moreover, this legislation does something a little different. That was really a one-time check. What this legislation does is to lower taxes for a period of a few years; and economists will generally conclude that the longer the tax change is for, that the larger the stimulative effect would be.

Mr. CAMPBELL. Okay. I am going to, before I run out of time, shoot you two more questions and then let you answer both of them so that I don't run out of time.

For the purposes of this question only, I am going to except Keynesian theory. But even within Keynesian theory, doesn't infrastructure spending have a greater multiplier effect? If you build a wireless Internet across the country, won't that generate a lot more private jobs than spending the money on government buildings or, frankly, on education in the short term? So I guess question one is, isn't there a lot better Keynesian spending than some of what is in here?

Second question, something we haven't talked about. We talked about Keynesian spending. We talked about the supply side. What there is hardly any of in this bill is any demand side incentives, such as large incentives for people to purchase homes or purchase cars, which are the two industries that brought us into this recession and perhaps maybe at some point could bring us out. Could you comment on the efficacy of any sort of demand side incentives?

Thank you.

Mr. ELMENDORF. Thank you.

So, first, on Keynesian stimulus, the principal way to think about Keynesian stimulus is putting dollars into people's hands that they then go and spend. So John Maynard Keynes wrote—and we had this in my prepared testimony today—that you could hide money in coal mines and then let private enterprises pay to dig it out. That would be better than doing nothing in a recession, because it would put money into the hands of those workers that they would spend. Now, naturally, we would be better off getting something intrinsically valuable.

So, in general, economists don't think that a dollar spent in a certain place has a different effect on demand than a dollar spent somewhere else. The reason the tax cuts are traditionally viewed as having smaller multipliers is that part of it is saved. But the basic point of a dollar spent by the government is that it becomes income to somebody; and if that somebody is building—is digging a trench for broadband or digging a trench for a school building, it is basically the same thing.

This is my time, not your time, I guess. Let me just say quickly, I think that Keynesian—the term Keynesian is viewed by some people today more negatively than I think is deserved. Keynesian economics does not answer all interesting economic questions. Economists have known for some time that Keynesian economics did not provide great insight into how to deal with the wage price spiral of the 1970s. It does not address the very important question of incentives created by government taxes and spending programs. But, in the judgment of most economists, it does provide a very important insight of what to do when there are vast amounts of unused resources in an economy. And notwithstanding all the various failings of Keynesian economics as Keynes understood it or some other particular professor understood it later, that insight is, I think, still very widely held among economists.

Now, your second question was about sort of I think more targeted policies to spur demand for particular items. I think a good case can be made for that, but so can a good case against it. It is in some ways effective stimulus to spur demand where there already is an operation ready to supply it. So if you can keep auto workers at work, rather than laid off, that can be very effective.

I think the counter argument is that we generally think that the government should not be picking which industries should be doing better or worse. So the risk one finds of helping demand in particular areas is that those areas, the areas that are chosen, may offer a role for the government that we don't normally support and don't think it is effective.

Chairman SPRATT. Mr. Blumenauer.

Mr. BLUMENAUER. Thank you, Mr. Chairman.

Thank you, Doctor. I want to follow up on your response to my friend from California a moment ago with the notion somehow that, because we stop the free fall in a year, that unemployment peaks, that somehow that is tantamount to a recovery. Now, it may be that our friends, based on the Bush administration's abysmal record of job creation, have defined down the definition of recovery, so that if unemployment is double digit and not getting worse, that somehow we have turned the corner and we don't have to worry about this stuff.

But I want to—your point about this continuing on through 2010, 2011, I would like to just take it one step further. I was on the committee 2 years ago. We had your predecessor, almost as smart and distinguished, before us and a distinguished array of economic experts of conservative, liberal, academic. I don't recall a great deal, with a great deal of precision, their forecasting our falling into this economic abyss. Is my memory failing me? Or were those certified smart people kind of missing the trench?

Mr. ELMENDORF. So I am one of the certified smart people who missed the trench.

Mr. BLUMENAUER. Okay. So the great precision that you are—not great precision. I mean, you have been very careful in qualifying this. But when my friend wants to wrap his arms around the hope that we stop the free fall in a year or two and that that equates to recovery, wouldn't you say we are, A, in uncharted waters; and, B, based on our past experience, Congress might err on the side of trying to help the public and the economy more rather than less?

Mr. ELMENDORF. I spent several years at the Federal Reserve Board heading up part of their economic forecasting group, and I think my experience has taught me that to call economic forecasting an inexact science gives too much credit. It is an inexact art, and our forecasts can be very wrong, and we report, in fact, systematically the errors we have observed in the past so people understand the uncertainty.

As I said earlier, I think most economists' response to the uncertainty today is to err on the side of providing more stimulus on the grounds that a stimulus can be withdrawn by the Federal Reserve more easily than it can be added.

Mr. BLUMENAUER. Thank you. I appreciate that clarification. I think it is important as we are going to move forward.

I also appreciated your analogy with burying the money in the coal mine and putting people to work. I mean, have you attempted to analyze, in great detail, how much residual benefit will come?

My good friend from Wisconsin flashed on the screen concerns about replacement of the Federal fleet or weatherizing Federal buildings, that somehow this is goofy. Doesn't that carry significant residual benefits for government operation and long-term cost savings?

Mr. ELMENDORF. The right kinds of investments, public or private, reap dividends over time. The estimates that I have offered you today do not incorporate any of those effects. We have focused for this purpose strictly on the demand side impact, which is likely to be most important in the short run.

Mr. BLUMENAUER. Right. And I appreciate your clarification, and I understand that. But I just want to make that part of the record, as people try and take potshots at something that we should make more ambitious rather than smaller, that there are elements here that have residual benefits that are going to help our work for years to come, save energy, improve efficiency.

The final point, and I would, if you want to clarify further, because I appreciate my friend from California bringing up, what is the difference between this and the last rebate that we threw out? The rebate that we had to make in that form because that is what the Republican administration and the Republicans in the Senate demanded. We would have had it be a somewhat broader net.

But I want to go to that notion of psychology. If most people—isn't there evidence to suggest that people getting a check in a lump sum are more inclined to look at that as a windfall, they are going to save it, as opposed to something that people get week after week after week in the take-home pay. Doesn't that influence purchasing far more?

Mr. ELMENDORF. I think, as I said, I think most economists' view is that the more lasting a tax change is the larger the effect.

Mr. BLUMENAUER. But my question was, what is in the check each week as opposed to a big windfall from the sky.

Mr. ELMENDORF. Yes. I think that is the intuition of most economists. I think there is not a great deal of evidence. I think there is some evidence about people taking a check as a windfall, and a change in take-home pay is not.

Mr. BLUMENAUER. I would respectfully request that you maybe help us a little bit with that. There was a fascinating little article in the New Yorker this week that seemed to indicate, I just read it briefly, that there is some research to that effect.

Mr. ELMENDORF. I think there is some evidence, but I think we just haven't run every fiscal policy experiment enough times to be sure.

Mr. BLUMENAUER. Thank you, Mr. Chairman.

Chairman SPRATT. Ms. Lummis.

Mrs. LUMMIS. Thank you, Mr. Chairman. It is Mrs. Lummis.

Dr. Elmendorf, my question is about cumulative impacts. When you add servicing our Nation's debt, plus the TARP payment, plus other spending that this Congress is likely to pass this year, plus the stimulus package, plus U.S. dependence on foreign energy, plus global spending by other countries trying to stimulate their economies, we are looking at, in my view, an unprecedented issuance of debt financing in the global markets this year. My question is, is there a saturation point? Is there a point that bottomless purchasing power by other countries of U.S. debt, coupled with debt of other countries, is reached? And is there any good modeling about the concerns that purchasers for the combined debts of global governments will dry up?

Mr. ELMENDORF. Well, Congresswoman, there certainly is some point at which it will become increasingly difficult for the U.S. government to borrow the sums involved. And you are right. The amount of borrowing is stunning.

In the judgment of most economists, we are not near that point now, despite the tremendous volume of borrowing. Interest rates on Treasury securities are low. Interest rates on private borrowing are not low in general, and that is because of the flight from risk. But at the moment interest rates and Treasury securities are low, even though the whole world has seen and made their own calculations of the anticipated deficits and the effect of the TARP and so on.

I think the reason that interest rates are not high is that borrowers, is that spenders are pulling back on their spending and doing more saving. And among those who are saving, there is a flight from private assets to less risky government assets, particularly U.S. government assets. So I think for the duration of this global recession, the condition is likely not to be certain but likely to persist.

As I said, I think the bigger risk comes—and this is, I believe, a consensus view among economists—comes over time, as the global economy improves, we expect, over the next several years, and people are more willing to invest in risky assets, less determined to buy Treasury securities and become more concerned about the long-run fiscal imbalance. So I think that risk is present today, but not large, but certainly rising over time; and that is one of the reasons why a criterion of not worsening the long-run fiscal imbalance is on our list.

Mrs. LUMMIS. Thank you. Is there a way to model global capacity to absorb global debt?

Mr. ELMENDORF. Yes, I'm sorry I didn't answer that, but I didn't have a good answer. I don't think modeling that is particularly difficult. Economists model lots of things. Lots of the models are bad. But I think international capital flows affecting the exchange rate and shifts in portfolio preferences are especially hard to model. So I don't think we have—and I will get back to you if I am wrong. I don't think that we at CBO have, nor have I personally seen, convincing models of those flows in a way that would add more to our understanding than the risks that you and I have just discussed. But we will check, and I will get back to you if we can do better.

Mrs. LUMMIS. Thank you, Mr. Chairman. I do have one more question. It is with regard to the multipliers that the administration is using of 1.5. Is it your position that that is a correct multiplier, and are you comfortable with that multiplier?

Mr. ELMENDORF. The administration report from Christina Romer and Jared Bernstein talked about a multiplier on government spending of 1.5, on tax cuts of about one. We developed our multipliers on a more granular basis. We have a set of them listed in my written remarks.

It depends exactly how you apply them to which provisions of the bill, so it is a little muddy. But our sense of this is that our multiplier and the multiplier they used are pretty close, and I think that is a reasonable multiplier.

The difference in our estimates of job creation come, I think, from differences in spend-out rates. They assume a faster spend-out rate than CBO has estimated, so they get more money flowing out at the end of 2010. So if you look at employment at the end of 2010, that faster spend-out leads to more jobs.

As I have said a number of times, I think we really want to look at employment over a period of time. The fact that the spend-out continues in 2011 under H.R. 1 is not a bad thing from the point of view of fiscal stimulus. You don't want the stimulus to go away overnight. You want it to taper down as the economy recovers. So we would find a substantial jobs effect in 2011 and so on.

So I think the differences that you see from our estimate to theirs are not particularly in the multipliers or the macroeconomic dynamics; it is more about when the dollars get out the door.

Chairman SPRATT. Mr. Etheridge of North Carolina.

Mr. ETHERIDGE. Thank you, Mr. Chairman.

Thank you for being with us this morning.

You mentioned to a question earlier, as related to the debt, the GDP in currently. I would be interested to know what that was in 2000, when we had projections of a huge surplus that was building out to as far as the eye could see, versus where we are and where the protections are now.

And while you look for that, let me add another piece to that question. Because in the proposed recovery and jobs creation legislation it is designated to do a number of things, one of which is to provide for support for school construction bonds that are in this package plus a number of other public facility bonds that would create a number of jobs, build new facilities for growing school districts and those that are decaying and other health facilities and communities. But it would also help the economy as a whole by creating jobs and generating revenue, which is critical as we move across.

My question, tied to my first one, is this, because I sort of feel like we are arguing above people's heads. Sort of reminds me of a guy who is standing in a mud hole, and he doesn't know whether it is a mud hole up to his waist or he is in quick sand and he is going to keep sinking. And so we can do nothing, and he can stay there, and when the sun comes out to get you dry and he would be in bad shape, or if it starts to rain he is really in a mess. And so the question becomes, do you do something or nothing? And I think the public is saying we want something done.

Now, we can argue about how we do it and what we are doing. So my question as it relates to this piece by creating the jobs, as you do your modeling, what is the magnitude of this as we create jobs as the multiplier and the other provisions that are in this recovery package as you're aware of at this point? And what are the specific ideas or items that have been mentioned in the package do you feel have a positive aspect as it relates to the slumping GDP? I mean, it is easy to figure out what will happen if you do nothing, I think. We are not really sure what it would be, but we think it is going to be bad. What happens if we do this and we start to have an effect, versus 2000?

Mr. ELMENDORF. I didn't find the number. I think that the debt was about 25 percent of the GDP in 2000. Ending the last fiscal year, it is about 40 percent of GDP. I think reasonable forecasts, including some fiscal stimulus, would push the debt to GDP ratio up toward 60 percent of GDP several years from now. That is a dramatic and unfortunate reversal in terms of the long-run growth path of the economy.

Mr. ETHERIDGE. And that was a decision made by people in charge in 2000.

Go ahead.

Mr. ELMENDORF. My tenure only started 3 days ago. But in the short run we think that all elements of the package, legislation as introduced, have some stimulative effect. And the choice among them depends on your judgment about the relative importance of timing and cost-effectiveness and long-run impact and who benefits and what society gets. And there are often trade-offs. Some of the things that are most desirable in terms of long-run growth may not pay out as quickly. Some of the things that pay out quickly may not have as high cost-effectiveness, and that is a balancing act that we can only provide information about but only you can make the decisions.

Mr. ETHERIDGE. Let me follow that up, because my question was we don't have a modeling of that to determine. I recognize you can't do that until you see the final piece.

Mr. ELMENDORF. We have in my written testimony today you can look at the results of our modeling. So we have taken the legislation as passed. We have determined a set of multiplier effects, essentially how much bang for the buck there is across a number of categories of the package. We have taken every bit of the categories and put it into one of these categories, and we have estimated the effects on GDP and then the effects on employment.

Now we have reported a range because of the great uncertainty. Our estimate is that we end up with a GDP growth, GDP by the end of next year, that is, as I said, 1.2 to 3.5 percent higher, employment that is higher by 1.2 to 3.6 million jobs, and an unemployment rate that is lower, by .6 to 1.9 percentage points. Those are very sizeable effects on the economy. Whether they are enough, that is a judgment you have to make.

Mr. ETHERIDGE. Mr. Chairman, I raise that question because, depending on where you are in the country, it has a greater impact. For instance, nationwide, your unemployment rates now are roughly 7.2; and the new numbers have come out. In North Carolina, they are 8.7; and we are shedding jobs by the thousands, not by the hundreds Statewide. And it has been in textiles, it has been in furniture, it is now in high tech, manufacturing. It goes down the list because we are a heavily manufacture State. As a matter of fact, 72,000 jobs were lost between November of 2007 and 2008.

Mr. ELMENDORF. As I say, it is a tremendous range in experiences across States. It is getting worse almost everywhere but at different rates and from very different starting points.

Chairman SPRATT. Mr. Austria.

Mr. AUSTRIA. Thank you, Mr. Chairman. Thank you, Dr. Elmendorf.

Let me just say that, you know, one of the things, you testified earlier that stimulating the economy now and reaching broader expectations is very challenging. And as I travel across my district in Ohio and I am sure most other areas across this country, there are real families that are hurting right now. There are small businesses in particular that I talk to, business owners that are reluctant to invest back into their business because of the uncertainty of the financial market, the uncertainty of the economy. And I think we all acknowledge that there is considerable weakness and uncertainty that remains in the economy, but I think what we are hearing today is the argument of a hefty infusion of government spending spread across 150 different programs within this package.

So, focusing on the short term, let me ask you, as far as fiscal policy, it operates with long and unpredictable lags. We are hoping, obviously, that the economy will recover quickly. And since much of the spending occurs far into the future, my question is, if the economy were to recover before large amounts of the spending occurs, should we go back and remove the fiscal stimulus?

Mr. ELMENDORF. I think the first recourse, if the economy recovers sooner than we expect, would be tightening of monetary policy. As I said, the Federal Reserve is finding increasing difficulty in easing policy but would not find it hard, I believe, to reverse course and tighten policy. Beyond that, certainly tightening of fiscal policy would be an option; and there would be a strong case for doing that.

One thing that you are seeing here in terms of the spend-out rates from appropriations bills is that policies set in motion take a little time to unfold. That would be true in reining projects back in, of course. Once a project has been authorized and digging has begun, presumably you would not want to stop it. But apart from that kind of restriction, I think it would be quite reasonable to consider tightening policy, yes.

Mr. AUSTRIA. Let me ask you, Doctor, if we are looking at the short term and we are spending a considerable amount of money in a very short time period, how do we make certain that this money is spent to deal with those real issues that are the real crisis that we have right now in creating jobs and improve the long-term productive capacity of the economy?

Mr. ELMENDORF. Well, I think that you could be looking at the effects on fiscal infrastructure and the effects on what I call human capital, a whole range of policies for education, for building of skills, for building of private manufacturing capacity, new equipment, for building of government and renovation of government buildings. All those things can reap benefits over time.

CBO released a study on infrastructure last year that tried to look category by category at the cost-benefit ratio of different forms of investment. Concluded, for example, that tens of billions of dollars of additional highway spending would pass a cost-benefit test, not that an arbitrary allocation of that money to highways might pass that test but that spent in the right places would pass that test. But, in fact, it is very difficult to do this category by category. There isn't that much evidence, to be sure. And we can offer some judgment about that, but also it depends on what your priorities are.

Mr. AUSTRIA. Doctor, let me just kind of follow up. You mentioned earlier that, you know, digging I think holes for infrastructure and digging holes for broadband basically give you the same results; and I think there are some that would that argue that if you want to create jobs you hire somebody to dig a hole and then you hire somebody to fill the holes. And getting back to infrastructure in particular, you know, the capital construction programs for public infrastructure are very slow spending, averaging I think it was 25 percent in the first year.

And then some have suggested that CBO is wrong, that this money will spend out much faster. I was hoping maybe you could comment and explain the estimates and how you derived those estimates.

Mr. ELMENDORF. So we have a lot of—"we", I am new—but we, CBO, has a great deal of experience watching these individual budget accounts over time. So a starting point in a sense is the rate at which money that is authorized normally turns into outlays.

In highways, for example, 27 percent of new budget authority is spent or outlayed on average in the first year. But then, beyond that, we look very specifically as what this legislation would do; and then we talk with people outside of CBO to gain more evidence.

In the case of highways, again, as an example, we talked with people in transportation departments in half the States representing two-thirds of national highway spending; and we talked with them about the speed at which they thought they could implement the legislation and spend the money.

And so, of course, there is a wide range of responses to that. Some States are more ready to go than others. But we do that account by account, and we have discussions, and then people refer to make further rounds of telephone calls.

Now, for all of that, we will undoubtedly be wrong in one direction or the other, but we try to pick a point where the odds of our being too low equal the odds of our being too high.

In this legislation, there were a number of themes across these various forms of increased appropriations. One is just that normal spend-out rates are not that high. Second is that we are starting midway through a fiscal year, so one just needs to be careful in looking at a table for comparison. A third is that very large increases in allocations—and there are some very large ones proportionally in this legislation, 10 times the last year's support for water projects, a much larger increase proportionally for broadband investment in rural areas and so on, that those tend to be spent out more slowly. So we make that sort of adjustment.

Chairman SPRATT. Mr. Andrews.

Mr. ANDREWS. Thank you, Mr. Chairman.

Thank you and welcome, Director.

Could you rank for us the efficacy of the stimulus tools, giving consideration to which one of those you think would get us closer to the upper end of your forecast range. In other words, I think we have a unanimous vote here in favor of a 3.5 percent in GDP instead of 1.2 percent. If you could rank the four tools, which are purchase of goods and services, grants to State and local governments, transfers to persons, and the tax cuts, in terms of efficacy and getting the upper end of that range, how do they rank?

Mr. ELMENDORF. Let me first quickly clarify, when we report, as we do, the multiplier effects, the bang for the buck by category, there is a high and low estimate for each category. For any given type of stimulus, we are quite uncertain about its effects.

Mr. ANDREWS. Of course. You are an economist. We understand that.

Mr. ELMENDORF. I mean, economists should be very cognizant of the uncertainty. Sometimes they aren't sufficiently cognizant. We—

looking across these categories, the types of stimulus that have the largest bang for the buck are purchase of goods and services by the Federal Government, transfers to State and local governments for infrastructure investments and transfers to persons. As I said, that is just one criterion of several in making this judgment. But according to that criterion of bang for the buck——

Mr. ANDREWS. And that is in rank order.

Mr. ELMENDORF. Yes.

Mr. ANDREWS. Do you know—and, if not, you can supplement the record, what the actual outlays will be for debt service in this fiscal year on the national debt versus what we anticipated in the budget resolution we did last year? I assume it is considerably lower because of the drop in Treasury bill rates.

Mr. ELMENDORF. We will need to get back to you on that.

I think there are two effects that I think work in opposite directions. Treasury rates are lower, but we are borrowing more money because of the worst economy. And I don't know offhand the balance of that.

Mr. ANDREWS. I understand. I would be interested on a per dollar borrowed basis how much lower it is.

And then, have you publicly announced a score yet for the fiscal year we are in of the TARP? Have you scored on the credit reform basis the TARP outlays we have done so far?

Mr. ELMENDORF. Yes, we have. There was a report—so in our annual budget economic outlook there was a reporting of that through the end of the year. And we have since updated that report, and there is a specific report that we are required by statute to produce.

Mr. ANDREWS. And what is that number?

Mr. ELMENDORF. The estimate I believe—but, again, this can change by the day, because we are looking at market valuations of assets. The latest estimate that I have is that the net cost, the risk-adjusted present discounted value of the commitments under the TARP I have is $189 billion.

Mr. ANDREWS. Is that based on the outlay of $350 billion in cash?

Mr. ELMENDORF. No, that includes our estimate of the use and potential losses on the entire $700 billion. Because the legislation for that was passed. Now we will just keep track of that as it is.

Mr. ANDREWS. Will that be a recurring number in each year's budget, or is that a one-shot credit reform entry?

Mr. ELMENDORF. It is one shot if we estimated it correctly. To the extent that we did not, there will be revisions that will appear in subsequent years. But it is not recurring at that level.

Mr. ANDREWS. When the Secretary sells assets, if he should recover a net profit from the sale of the assets, how will those revenues be booked for budget scoring purposes?

Mr. ELMENDORF. Our approach to this, estimating these costs under our judgment and under the legislation as it was passed, is to calculate on a risk-adjusted present-value basis. So the purchase and sale, per se, have no direct effect on the budget cost, except to the extent that they demonstrate that our estimate was wrong.

Mr. ANDREWS. But if your 189 hopefully underestimated the revenues, if it was as conservative as it should be, how will we then get the benefit of that in future years' budgets?

Mr. ELMENDORF. What you will see is that the debt of the—the outstanding Treasury debt will decline. So it has risen more than the deficit says, because we have been playing this financial role, and it will decline more as well.

I would just mention, to clarify, OMB has been scoring this on a different basis. Our reports try to tell you our view as required by legislation but also to express them on a basis more comparable to OMB. So far at least, they have done theirs on a cash basis.

Mr. ANDREWS. Understandably.

Thank you, Mr. Chairman. Thank you, Director.

Chairman SPRATT. Mr. Harper of Mississippi.

Mr. HARPER. Yes, sir.

Greg Harper from Mississippi. How are you? And congratulations. And we don't envy your task that you have, but we certainly appreciate the effort you made to get the numbers right.

My question is, are there any things in this package that you just think shouldn't be in there?

Mr. ELMENDORF. That's not a judgment I can reach, Congressman.

Mr. HARPER. Well, from a budget standpoint, are there things in there you think are not stimulus?

Mr. ELMENDORF. Every increase in government spending or reduction in government tax revenue we think provides some spur to economic activity. The amounts can differ. But, as I have emphasized, there are also differences in the timing of the effects and differences in other characteristics. I don't have a way to consolidate all of that into a single measure of good and bad. All I can do is to tell you how these possibilities rank under the alternative criteria and then different criteria and then you have to put together.

Mr. HARPER. Forgive me for putting you on the spot like that, but do the deficit numbers, this huge deficit spending, does that trouble you as an economist?

Mr. ELMENDORF. I think that anybody who is paying serious attention to the U.S. government budget, both the present and the future, is concerned and has been for some time. I think it worries me more now because we are adding a lot of debt, even without additional policy, and I think you are about to implement additional policy.

But, to be clear, it also worries me a tremendous amount that we are in a recession the likes of which I have not seen and hope to never see again in my life and with monetary policy employing tools that we have never used in at least 75 years and so on. So a lot of things worry me now. The deficit is one of them.

Mr. HARPER. Okay. Do you anticipate that as we address what is going to be an incredible growth in the budget deficit, do you anticipate that tax increases will become necessary down the line to deal with those issues? And if we do the tax increases, will that derail the recovery?

Mr. ELMENDORF. I won't predict what you will vote for as a Congress. I will predict that the scale of spending reductions or tax increases necessary to move the economy, to move the budget back into balance will be very substantial.

Mr. HARPER. Do you anticipate or is it a goal that we have a balanced budget? Is that—do you see that as a goal we should have?

Mr. ELMENDORF. I think it would be a consensus view among economists that something much closer to balance than the CBO currently projects makes sense. Whether zero is the precise goal you could get more professional arguing about, but the notion that we should be moving back toward greater balance than we foresee in the baseline projection, I think it would receive very little objection.

Mr. HARPER. You know, in Mississippi we have had some problems in the housing market last year and some other problems that were going on. But the real problem came to bear when we started paying $4 a gallon for gas at the pump. And it hurt a lot of students. You know, our State people do have to drive a reasonable distance to get places; and that had a profound impact on seniors, people that were on fixed incomes and workers. It was—it hurt all of the small businesses in a great way.

Wouldn't it stimulate the economy if we did things to get our own natural resources, drill for oil in ANWR, drill offshore? Wouldn't that have an impact on consumer confidence and gas prices and help us, you know, sell more cars?

Mr. ELMENDORF. The decline in the price of gasoline is one of the few bright spots for the U.S. economic outlooks. Of course, that is a reflection of weakening global economy. But just by itself it is a bright spot. Obviously, that is—a greater extraction of natural resources that you propose has other, raises other considerations.

Mr. HARPER. What happens if we do this plan and then we have really done nothing to do anything about going to get and increase our supply of fossil fuels at this point to help us during that time? What happens if we go to $4 a gallon again 6 months from now in the middle of this attempted recovery?

Mr. ELMENDORF. That would be another blow to economic activity, no doubt. I think unlikely, given the global economic conditions, but possible; and that would be unfortunate.

Mr. HARPER. Thank you.

Chairman SPRATT. Mr. Edwards.

Mr. ELMENDORF. Dr. Elmendorf, I am glad to hear there is concern from Republicans as well as Democrats about the deficit.

I am angered by the level of deficits we are having to face. But as I listen to the discussion of it, after having been on this committee for 6 years, I am reminded of the wisdom of the former Speaker of the House, Sam Rayburn, who said, there's no lesson learned in the second kick of a mule.

I would apply that to this committee in this sense, that in 1981 President Reagan and Republicans, along with a number of Democrats in the Congress, bought into the idea and sold the idea that we could have a massive increase in defense spending, balance the budget and pass massive tax cuts. David Stockman later in a moment of honesty wrote a book and admitted that was a false promise, and he knew that it was. You couldn't do all that and balance the budget. We ended up with the largest deficits in American history.

The second kick of the mule was 20 years later when Republican colleagues, including members of this committee, who wrote the budgets at the time because they were in the majority, once against promised us that we could have it all. We could have massive tax cuts, balance the budget and even fight a war in Iraq and Afghanistan and balance the budget.

Well, that second kick of the mule resulted in the largest deficits in American history. I just hope we have learned the lesson from Mr. Rayburn and don't have to go back to the third kick of the mule. Because what I am hearing from some of the very architects of the budgets that I think contributed greatly to the economic mess we are in today are proposing, all we need now to get out of this mess that they helped create is more tax cuts, unpaid-for tax cuts, $4 trillion of unpaid-for tax cuts that would increase the national debt far more than the spending in this bill.

I am glad there is bipartisan interest in the deficit today. I wish some would go back and look at the predictions some of us made in 2001 and 2003, versus the predictions made by those that said we could have it all, the tax cuts and balance the budget, and determine who was right and who was wrong. But at least we are at a point now where I am very happy there is bipartisan concern about the deficit.

So let's go directly with that point into the deficit caused by this stimulus package if we pass it. I wish we didn't have to increase the deficit this year or next with the stimulus package. But having voted against the budgets that led to this mess, I am going to be part of voting for a stimulus package that hopefully helps us get out of it.

You projected that the CBO says that the stimulus package could increase the GDP by as much as 3.6 percent in 2009/2010; on a minimum side, 1.3 percent. Tell us how much the deficit would be reduced compared to not doing anything if this stimulus package actually increased GDP by 3.6 percent. Because, obviously, economic growth and output help reduce deficits.

Mr. ELMENDORF. As we say in the cost estimate, it does not include the dynamic effects of strong economic growth. We have done a back-of-the-envelope calculation of that. It is pretty straightforward to think about. In general, a dollar of extra GDP reduces the government budget deficit by about $0.20, and that is mostly through higher tax revenue, a little bit through lower spending on means-tested programs and so on.

Mr. EDWARDS. So if you increased the GDP by $1 trillion, as you projected this package could do, that is in effect reducing what the deficit otherwise would have been by about $200 billion; is that correct?

Mr. ELMENDORF. Yes. So that is closer as you asked to the high end of the range that we—of economic outcomes, the average of the high and the low outcomes that we track. The midpoint of those has a multiplier of about one. In that case, 800 or so billion dollars of extra deficit would lead to a fifth of that, or about $160 billion of sort of feedback from the economy and, in fact, would be smaller if we were on the low end or larger if we are at the high end of our range.

Mr. EDWARDS. You have also said one of the key criteria in this package should be not creating long-term additional structural debt or deficits. Would the $4 trillion that some have proposed in additional tax cuts that aren't matched by spending cuts, would that increase the long-term structural deficits of this country significantly?

Mr. ELMENDORF. Yes. Large permanent tax cuts would exacerbate the long-run fiscal imbalance if they were not combined with some offsetting change elsewhere in the budget.

Mr. EDWARDS. Thank you.

Chairman SPRATT. Mr. Aderholt.

Mr. ADERHOLT. Dr. Elmendorf, thank you for being here; and, of course, congratulations on your new role as Director of the Congressional Budget Office.

Mr. ELMENDORF. Thank you.

Mr. ADERHOLT. Just one thing that many of us have noted, that out of the $500 billion in the spending plan that has been proposed, only about $30 billion will be for highways; and a lot of—much of the rest of that amount will be for various government programs in ways that appear, at least on face value, to not have a stimulative effect, such as maybe the $50 million for the National Endowment for the Arts. How much of the $500 billion would you say will actually stimulate the growth and create jobs in the economy?

Mr. ELMENDORF. In our estimation and I think the estimation of most economists, all of the increasing government spending and all of the reduction in tax revenues provides some stimulative effect. People are put to work, receive income, spend that on something else. That puts somebody else to work.

And for short-term purposes, what really matters most is how many extra dollars get spent, and that is why Keynes used this imaginary story about putting money in mines and paying people to dig it up. It is just the act of getting purchasing power into the economy.

Now, over time, putting money in mines and digging it up does nothing for our consumption possibilities or the future growth of the economy. So spending the money on something else presumably makes much more sense. But in terms of the direct effect, it is either the spending or the taxes in a variety of categories, and the differences amount to how quickly it happens and to the bang for the buck. But nothing really has the bang for the buck of zero.

Mr. ADERHOLT. So what percentage of that, out of the $500 billion, would you say actually would stimulate the economy, in your opinion?

Mr. ELMENDORF. I think all of the $800 billion provides some stimulative effect. The extent of stimulus varies by categories. But it all matters, all of it.

Mr. ADERHOLT. The President has talked about saving or creating three million to four million jobs, with 90 percent of them in the private sector. About $200 billion to $300 billion in this proposal, somewhere between 25 and 35, 36 percent, will be spent on government programs that have very little connection to the private sector. Even accepting the administration's estimate, how many government jobs would this bill be creating?

Mr. ELMENDORF. I am sorry, that is a question we have not tried to answer. It is quite complicated. The estimates that we have made, as I say, divided all parts of the bill into half a dozen categories with different multiplier effects, different bang for the buck. But to address the private sector job count, we would have to drill down much deeper and really investigate what happens at a very particular level.

So there will be some highway projects that will involve private contractors and some that will involve government employees. There can be school construction done by employees of the Montgomery County Public School System and some school construction done by private employees under contract to the Montgomery County Public School System. So to figure out who is actually getting a government paycheck and a private paycheck would be very complicated, and I am not sure we could, and we have not tried.

Mr. ADERHOLT. What are your thoughts as far as taking a government job and stimulating the economy as opposed to private sector jobs and as far as how those compare and as far as the overall stimulation of the economy?

Mr. ELMENDORF. Again, in terms of the short-term stimulus, either kind of job works because the people who get those jobs and receive the paycheck go out and spend it; and that is—or spend much of it, and that is the multiplier effect that economists talk about. I think the differences would come down to what you judged as the most effective in supporting long-run economic growth more than in terms of short-term stimulus.

Mr. ADERHOLT. I see my time is running out, Mr. Chairman. I yield back the rest of my time.

Chairman SPRATT. Mr. Scott of Virginia. Mr. Larsen of Washington had to leave. Mr. Schrader.

Mr. SCHRADER. Thank you, Mr. Chairman.

I appreciate the discussion here today, and I just wish some of those that have evinced concern about the deficit that we seem to be incurring this current year were willing to speak up over the previous 8 years where we ran a $10 trillion debt. And I guess if that is the low mark we are aiming for, geez, we have got a lot of room to work here in the next few years of this administration.

Having said that, I do have some concerns about the debt we are accumulating. I agree with Mr. Andrews. And I go to your figure one that you have in your document; and when I look at the recovery in the outyears, you paint a linear picture. We get back to the same linear rate we had prior to the recession.

And I guess my concern—and I would like your opinion. My concern is that that linear rate is not going to be—is not going to recur, that indeed the growth rate and our GDP will be significantly lower than that linear rate because the previous years were based on the Ponzi schemes of the 1980s, with merger mania, you know, get-rich-quick schemes that empowered the wealthy, threw a lot of working men and women out of their jobs, the dot com bubble of the '90s and here now the thought that my house is always going to be worth more than I paid for it.

So those get-rich-quick concepts are no longer there; and shouldn't we be moderating our GDP expectations, hopefully, in a more value-based economy where there is real production and real value to what we are doing? So I am concerned we are not going to have the tax revenues needed to pay for our programs and do the things we want to do in the outyears.

Mr. ELMENDORF. You raise a number of issues. Let me say, briefly, the potential GDP line in this picture actually is affected a little bit by the economic downturn. We have much lower investment and spending projected for the next several years. Businesses tend not to invest as much in recessions. That lowers the amount of capital that we will have down the road. In fact, if you look carefully, there is a little bit of flattening of the potential output.

The other issue you raise I think involves the demand, the potential supply of goods. You also raise questions about the demand for goods. The bubble economy, the rise in value of stocks and houses, has encouraged consumer spending in a way that is not likely to be repeated soon; and the huge losses are holding down spending by households and will for some time.

Over time, this projection says that the policies under current law will eventually pull us out. That is a feature of economies that eventually they tend to right themselves. Consumer spending adjusts for lower wealth but then will start to pick up again and so on.

We might be wrong about that, certainly. But we hope to have balanced the risks. I think—but it is a problem for the next several years, certainly, of not having sufficient demand for goods and services to put people back to work; and that is why I think this consensus has developed on behalf of some form of fiscal stimulus and some form of financial monetary policies to try to return people to work more quickly. And I think there will definitely be less risk taking, less financial engineering than was the case a few years ago. That should not hinder, if anything, possibly, by redirecting smart people's attention to other aspects of the economy, could help long-run growth.

Mr. SCHRADER. If this package did not include any aid to our States that basically deliver the education for America, that provide for the health care of millions of individuals in our great country and make us safe in our own homes with our public safety budgets, what would be the effect not just on the economy at large but on those individuals and those institutions back home?

Mr. ELMENDORF. I believe there is a report from the GAO that estimates that operating budget deficits of State and local governments in the next 2 years will exceed $300 billion. Those governments are under various degrees of pressure to balance their budgets. That will mean tax increases or spending cuts and of a scale that we have not seen in some time. With house prices falling, property tax revenues will go down. With consumer spending falling, sales tax revenues will go down. The cutbacks will be large, and the provisions in H.R. 1 would offset some part of that. That is about as specific as I can be.

Mr. SCHRADER. Thank you.

Chairman SPRATT. Mr. Simpson of Idaho.

Mr. SIMPSON. Mr. Chairman, I don't really have any questions except a couple of statements and I guess to welcome you to your new position.

Basically, if all government spending is stimulus, why stop at $825 billion? Why not go to 2 or $3 trillion? I mean, if we are going to stimulate the economy, let's really do it.

Mr. ELMENDORF. Well, sir, there are people who have made exactly that argument for why this policy is not sufficient.

Mr. SIMPSON. I was afraid of that.

Mr. ELMENDORF. I think the answer—and I am not sure what the right size of package is. I don't think there is a consensus among economists about how much to do. I think the considerations involve the loss of output and income in jobs. So even with H.R. 1, by our estimates, there is still an unemployment rate that is substantially above what we have gotten used to over the last 7 years, lower employment than we would otherwise have. So even with H.R. 1, a package of that size, there is still a substantial shortfall in economic activity relative to what we could be doing. So some people see that and say that more should be done. People also say that we are uncertain; and because we are not sure if things got worse, that might be very bad, another argument for doing more.

On the other hand, people say, look, $800 billion is a lot of extra debt to incur. It imposes a burden on the future. And maybe we also need to be working through financial and monetary policies that might be particularly effective at getting the economy going again, and that is why some people would say we should have smaller numbers for fiscal stimulus. And those are all legitimate arguments.

Mr. SIMPSON. Let me ask you a question. This gets back to what Mr. Blumenauer was talking about when we criticize some of the particular spending proposals that are in this economic stimulus plan, a lot of them that are spent out in 2 and 3 and 4 and 5 years down the road.

We have a normal appropriation process here. If there is only so much of this money that is going to be spent this year, why not go through the normal appropriation process? As an example, there are something like 32 new programs that have never been authorized by Congress or anybody else. I don't know whether they are effective or the right way to be spending money, other than they were dreamed up in somebody's office and put into this bill.

Why not—if the money is not going to be spent this year, why not go through the normal appropriation process and do it where we have hearings and oversight and determine whether the money is best effectively spent there or somewhere else? If all government spending is stimulative, we are operating right now on a 2008 fiscal year—on a 2008 budget year because of the continuing resolution. That means that the increases in spending that we had in 2009, we are a third of the way through this fiscal year and we are not spending that money because we are operating at the 2008 level.

Would not having passed the 2009 appropriations bills on time, as we should have done, not also been a stimulative, that increase in spending that we would have had.

Mr. ELMENDORF. Yes, it certainly would have been.

Mr. SIMPSON. We have $500 million that we have put into that stimulus package for EM cleanup. It is very near and dear to my heart. EM cleanup is spent in different districts around the State, at the Idaho National Lab. We put $500 million into EM cleanup. We actually had an increase in the 2009 appropriation. Had we passed that, we probably wouldn't have had to put $500 million into a stimulus package.

What seems to me is that what we are trying to do is spend money on every good idea somebody has had in the back of their brain somewhere for years and years and put it into an emergency stimulus so that we can pass it, instead of going through the normal appropriation process. That is what many of us are complaining about. Not that we don't need a stimulus package. We all believe we need a stimulus package of some sort. It is the way we are doing and the way we are avoiding the rigmaroles of the regular legislative process that concerns most of us. Most of us, if this money is being spent out there this year, this is fine.

I will tell that you when the stimulus passed last year the $500 or $600 checks that went out to everybody, I voted against it. I reason I voted against it is I didn't think it would have any very long-term effect. And if you look at the economic numbers it is barely a blip in the economic scale as to what it had. I thought we would spend it better by doing infrastructure projects.

I was told by then OMB Director and by Bernanke that those projects take so long to get out there that the money won't go out. And, in fact, we have shovel-ready projects in the States, some $67 billion, as I understand it, where we are only putting $30 billion into it, that are ready to go today.

I do not have a problem with that kind of stimulus program. But when we are sitting there looking at programs that will be spent 2 and 3 and 4 years down the road, I think we need to go through the regular legislative process.

The other thing I would note, just because somebody needs to respond to some of the rhetoric that has been going on, Ms. Schwartz said in her testimony when she was comparing the relative value of spending versus tax cuts and so forth and the balance that ought to occur there, that apparently Republicans only wanted tax cuts and then only for the wealthy. That was her exact words.

Apparently, she hasn't read what the Republican proposal is. We would drop the 15 percent rate to 10 percent, the 10 percent rate to 5 percent. That means anybody on the first 10 percent of their income, on the first $16,700, lowering the rate to 5 percent. I don't know that I'd call that the wealthiest individuals in this country. Maybe that fits her category, but I am tired of the worn-out rhetoric.

We have a legitimate debate about how much of this should be in tax relief and how much should be in spending, and we ought to focus on where this ought to be.

Chairman SPRATT. Thank you, Mr. Simpson.

We now go back to Mr. Scott.

If you suspend just for a minute, the Republican members have a meeting with the President at 12:15. We, by all means, want to accommodate, so we are going to take a break right at 12:15. We will take one more round of questioning to finish out, if that is agreeable for everybody.

Mr. Scott.

Mr. SCOTT. Thank you, Mr. Chairman.

Mr. Elmendorf, we have heard a lot about the situation and need for stimulus. My question is, does the difference between stimulus priming the pump and expenditures as we have just heard that go for long periods of time, do we need a stimulus to just prime the pump or do we need long-term spending to get us out of the mess we are in?

Mr. ELMENDORF. I think most economists expect that in absence of new fiscal policy the economy will be well short of the potential number of jobs, amount of income for several years, 2009, 2010, well below in 2011, and still below in 2012. The number of forces that I mentioned are leading to a slow recovery in our estimation and the estimation of most economists. And that is the case, all else equal, for fiscal stimulus that lasts for some time.

Mr. SCOTT. So when we talk about timely, targeted and temporary, timely and temporary means several years?

Mr. ELMENDORF. Yes. So one difference I think now, the discussion now from the discussion last winter, that last winter there were people predicting a long, deep recession, but that was not the consensus. There was much more uncertainty at the time, much more of a sense of what was needed was a quick jolt. I think now, with the deterioration we have seen in the economy and the financial system over the past year, has moved people to looking over a longer horizon.

Mr. SCOTT. Would there be an advantage in getting jobs that could be done extremely quickly? I am speaking I guess specifically about summer jobs, because people would be hired in a matter of months.

You have shovel-ready projects for which people have told us they can get people hired within 120 days. There seems to be some question about that, but the 120-day figure is something that a lot of the Departments of Transportation around the country said they could meet. But summer jobs, they have to be on the job, and it is temporary. They are off the job by the end of the summer, and they are relatively inexpensive. A few hundred dollars, maybe $1,000, $2,000, no more than $4 or $5,000 per job. You have people up and working.

Would it make sense to increase the number of jobs that you know will be up and running this summer, education programs, summer camps, other jobs for youth, youth build and those kinds of things?

Mr. ELMENDORF. It certainly is useful to get money out the door as quickly as possible. This summer qualifies for that. I think the greater challenge is in trying to organize the people, select them, put them to use at constructive tasks. I think that is a challenge, and I don't know enough offhand to judge how much of that could be done.

Mr. SCOTT. Let me tell you, if you give community action agencies notice, 2 or 3 weeks notice that there are summer jobs available, they will not run out of young people to take those jobs. You could do other things like in Federal agencies have internships and those kinds of things. You can increase funding for Upward Bound. There are a lot of things that you could do for which there would not be a lot of confusion in getting people on the job working, receiving paychecks by this summer.

Mr. ELMENDORF. I think the challenge is in getting the money from here out across the States and across the communities. So, for example, our conversation with State Transportation Departments, one of their concerns is the highway money that is directed to local governments. Not that the local governments can't use the money, but it is one more step in the allocation process, and it takes time. And I think there is some underlying trade-off. The more that you want to influence who gets the money and what they do with it, the harder it will be to move very quickly.

Mr. SCOTT. Something like summer camps run by local recreation programs, those could be put together fairly quickly.

Mr. ELMENDORF. I agree. I am not an expert at that, as I've said. I think the issue is you need to decide which summer camps, where in the country get the money, and then you need a process for keeping track of whether they deserve the money and what they do with the money.

Mr. SCOTT. You tell school systems, local community action agencies—let me tell you there would not be a problem getting people hired in programs designed this summer if we act within the next couple of weeks.

Thank you, Mr. Chairman.

Chairman SPRATT. Thank you, Mr. Scott.

Let take one more question from Mr. Langevin, and then we will recess the hearing for about an hour. We will come back at 1:15.

Mr. LANGEVIN. Thank you, Mr. Chairman.

Mr. Elmendorf, thank you for being here today. Welcome aboard and congratulations in your new role. It comes at a challenging time.

Mr. ELMENDORF. Thank you, Congressman.

Mr. LANGEVIN. I know we have gone over this a couple of times, but, again, the difference in GDP if we do nothing versus enacting the stimulus package as proposed.

Mr. ELMENDORF. Our estimate is that in the fourth quarter of 2010 GDP would be higher by 1.2 to 3.5 percent if we implemented H.R. 1 relative to doing nothing.

Mr. LANGEVIN. Thank you.

In my State, most of our businesses for job creators are small businesses; and I know the programs like the 7(a) loan program through SBA have been highly effective. I am not certain, as I am still looking over the details of the stimulus package, I don't necessarily see anything yet that increases 7(a) loan programs. Would that type of investment be a multiplier that would be worth undertaking and worth investing in this stimulus package? And at what level should we invest if we were going to do that?

Mr. ELMENDORF. I think—as I said, I think money that gets pushed out to hire people to do something stimulates the economy; and for short-term stimulus it doesn't matter much exactly what they do. But it can matter a lot over time, depending on whether we want to move the economy in more energy efficient directions or with different infrastructure or what have you. And, also, I think the speed varies across sector. It is more difficult to scale up programs to a very large order of magnitude or not.

So one constraint—I am not an expert at every possible part of the economy or every part of this package, to be clear. But I think it can be a constraint just how much money can go into some area all at once. And it is a constraint in terms of what the Federal Government can manage, what State and local governments can manage and also what the private sector can do.

We need trained workers to do certain tasks. At the end of last year, a survey of transportation contractors, a quarter of them reported a shortage of skilled labor, not so much unskilled labor but skilled labor. So there are going to be constraints in terms of the real economic activity in terms of workers and materials and so on that can be an issue.

Mr. LANGEVIN. I don't know if that answers my question. Let me ask you it a different way.

Would you like to see a greater investment in support of the 7(a) loan program in the stimulus? Would that be something that is positively viewed, or should we leave it where things are?

Mr. ELMENDORF. So I think—again, I don't make recommendations on what I would want, but I think more of that would provide additional stimulus to the company.

Mr. LANGEVIN. Mr. Chairman, I hope we could encourage that in the stimulus program. In a State like mine, where small business accounts for about 95 percent or greater of the jobs in our State, that is something that would be of great benefit.

My final question really focuses on the national debt, and this is something that I have been concerned about for quite some time. I even intend to vote for the stimulus package. I am of the opinion, as others are, that we have to do this, that doing nothing is just unacceptable and would make the situation worse.

At what risk, at what level of debt do we get to the point where that level of debt is really unsustainable? How much room do we have really before we have hit a ceiling and can no longer deficit spend, that the national debt crosses a threshold that is just at a level that is unsustainable?

And the second half of that is, what tools in the future would be most effective in paying down the national debt? Even if they are creative solutions, things we haven't yet thought of, a national sales tax or something that doesn't even exist right now, but what tools would be most effective in bringing down that debt?

Mr. ELMENDORF. We are on a path—as I say right now, Federal debt at the end of the last fiscal year was about 40 percent of GDP. We are on a path to push up it to about 60 percent of GDP several years from now. That would be the highest ratio of debt to GDP that we would have had in this country since the early '50s when we were coming down from the very high debt incurred during the Second World War.

Other countries have operated for years with more debt. Their excess levels of debt tend to worry people. Their securities are not viewed as the security you most want to have in a financial crisis like ours are.

So there are certainly risks. It is very difficult to know where the tipping point might be. One could go on for some time accumulating debt. But at some point, as concern rises—and it is not just the current level of debt but the forecast—at some point then there could be a rather abrupt reaction, and economists are not good at predicting what that is.

Policies you could undertake, anything that raises taxes or cuts spending numerically does the trick. We can talk with you about the effects of different policies on incentives in the economy, on long-term economic growth and on the well-being of particular individuals, but those are really what the choices will come down to.

Mr. LANGEVIN. Thank you, Mr. Chairman.

Chairman SPRATT. Dr. Elmendorf, thank you very much for your testimony. We have a couple more questions to put to you. Because of the present situation with the Republican members, we are going to recess the hearing until about 1:15.

Have we covered all the Republican witnesses? Have we? We have two more on our side to ask questions. John? Marcy?

Agreeable to you, we will dispose——

Mr. ELMENDORF. I am at your disposal, Mr. Chairman.

Chairman SPRATT. Two more witnesses. Bear with us just a moment.

With your understanding, we will go to Marcy Kaptur and then come back to you; and that will wrap up the round of questioning.

Ms. KAPTUR. Thank you, Mr. Chairman. That shows great sympathy for our guest and for all of us. We appreciate it very much.

Let me place on the record that today in Ohio, in Toledo, my home, unemployment has risen to 10.7 percent, up from 7.0 last year; in Sandusky, Ohio, 11.4 percent, up from 8.4 percent last your; Lucas County, 9.9 percent, up from 6.5 percent; Erie County, 9.8, up from 7.3; Ottawa County, 12.4 percent, up from 9.1 percent. According to the numbers we have, there are currently 11,100,000 Americans unemployed; and by this year's end we anticipate it could reach over 12 million.

The statement I want to make is that putting people to work now, applying hands and minds in useful enterprise, is the most important step we could take, rather than sidelining individuals to help this economy move forward. And so my question, Doctor, is, as I look at your testimony, you say even if we pass this, the number of jobs created this year could be less than a million or maybe as much as 2 million. That is so small in terms of the need; and, therefore, I must ask the question, which programs in the stimulus are best suited to put to useful work those who are unemployed?

That is my first question.

Mr. ELMENDORF. So I think if you look across pieces of the stimulus legislation there is some trade-off between the immediacy of the effect and the ultimate bang for the buck. So the parts of the package that put money into the economy most quickly are the changes in tax policy and the changes in entitlement policy. Slower spend-out rates rise in the appropriations parts of the package in general.

However, our judgment, drawing on the consensus of the economists you use, is that direct appropriation spending by the government has a large bang for the buck over time. So there isn't a single—just looking at those first two criteria that we talked about, the timeliness and the cost-effectiveness, there isn't a simple ranking of the pieces of the package. There are some pieces that are both fast and have a high bang for the buck. Those tend to be payments to low-income individuals.

Ms. KAPTUR. But that doesn't put people to work if they are getting an unemployment compensation check.

Mr. ELMENDORF. Well, no, it does, because they take the money and they spend it. And the reason it has more stimulative effect than a broad-based tax cut would is because, though people have lost their jobs and are subsisting on an unemployment insurance check that is a fraction of what their previous earnings were, are likely to spend a large fraction of that check. So it doesn't put them back to work, but it does keep to work the person in the clothing store or the auto dealership.

Ms. KAPTUR. I hear you on that. But one of the difficult parts on this is people want to work. They don't want to receive subsidy checks, even though they have earned them through their years of work.

So my question is, in this program you mention some of the transportation projects, for example. You know what we need in our cities right now? We have got to fill potholes. We have to buy the asphalt to put in the potholes. This is not glamorous. You were talking about smart people. I think we need responsible people, we need good people, we need ethical people, we need people who have experience, and we need to put people to work.

Sometimes you can be sort of overeducated. My goal is to get people to work to do useful work that is needed right now. We need trees cut down. We have got 20 million trees in Ohio and Michigan that have to be cut down. We could put them to work tomorrow.

What programs? Can you go through this list? If you can't do it right now, can you tell me one, two, three, four, five, which are the ones that can put people to work the fastest?

Mr. ELMENDORF. So I will go back—I can't tell you offhand. I can go back and check which are the specific items in legislation we think would spend out fastest. But you might be surprised. So highways is not a category that we think spends out particularly rapidly. And that is not a judgment that there are not immediate needs, as you say. The judgment about the process of getting money all the way through the chain to the person who needs to get paid to fill in the pothole. And we have talked with Departments of Transportation in half of the States accounting for two-thirds of national highway spending, and some of them were optimistic and some less so about their ability to put money out the door right away.

Generally when we have seen big increases in spending on highways, for example, it is not all fancy. Some of it is basic work. When the budget authority goes up, the outlays follow with a lag. Between 2006 and 2008, budget authority for highways rose by 17 percent, but outlays rose by only 10 percent. There are now tens of billions of dollars of unobligated balances in the highway fund, money that has been authorized by Congress and not obligated yet by the States. It is simply takes time, and that is the challenge.

I will go back and check which pieces moves the fastest.

Ms. KAPTUR. Yes, because to have that low a rate of reemployment is very troubling to this Member.

Chairman SPRATT. Thank you, Ms. Kaptur.

Mr. Yarmuth.

Mr. YARMUTH. Thank you, Mr. Chairman.

Welcome and congratulations.

Some critics of this proposal have characterized it as throwing everything against the wall and hoping something will stick. I think I heard that over the weekend. And you mentioned before, and I agree with you, that desperate times require desperate measures. And I actually characterized it as to pretty much the same thing, that we are throwing everything we have at our disposal, given that we don't have monetary policy to use, at this desperate situation.

Mr. Scott has mentioned something that we haven't thrown yet. Is there anything else that you at the CBO can think of that we would throw at this situation that we haven't thought of?

Mr. ELMENDORF. I—that is a fair question. Unfortunately, I don't have a great answer. I don't have offhand in my mind a list of obviously overlooked opportunities, but I will give that more thought and let you know promptly if I have further ideas.

Mr. YARMUTH. Thank you.

We had some discussion earlier about job creation and how much it was estimated it would cost to create a job, $140,000 to twice that or whatever the discussion was. And you just alluded to the issue of saving jobs as well as creating them. Is there any way to estimate how many jobs saved—and, obviously, I would think it is a much more difficult assessment—but is there any way to estimate how many jobs could be saved by this plan, as opposed to created?

Mr. ELMENDORF. Our estimate is the difference in the net total number of jobs in the economy. So it reflects some combination of jobs saved and jobs created. We don't really have a way of keeping track of that separately.

As you know, there is a tremendous amount of churning in the U.S. economy, the labor market on a regular basis. A tremendous number of jobs created and lost with the net being the difference between them. And what we have estimated here is the net difference in jobs under this plan versus without the plan. I am not really able to do that break down.

Mr. YARMUTH. Well, I asked the question almost rhetorically almost. Because you mentioned that you were a little bit concerned about the use of jobs as the one standard in evaluating the success of this program, and I share that concern.

You also mentioned—you have used the phrase several time—the ultimate bang for the buck. In your definition or CBO's definition, what is "ultimate"?

Mr. ELMENDORF. What I mean by that is, as the dollar goes out of the Federal budget, what is the effect on GDP? So whenever the dollar goes out, what does it do to GDP?

Mr. YARMUTH. So the ultimate bang for the buck does not, for instance, calculate the cost to the economy and society of neglecting some of these things that will be neglected because of the desperate situation that we are in?

Mr. ELMENDORF. No. This is a much simpler estimate, just referring to the macroeconomic impact, without taking account of either the underlying trajectory with or without the plan in terms of the quality of our public utilities and so on.

Mr. YARMUTH. Right. And the cost to society and to the ultimate economy, the long-range economy in the cuts in education that would ensue if we did nothing to support the States and their efforts.

Mr. ELMENDORF. Right, we have not looked carefully at that aspect.

Mr. YARMUTH. One thing—and this is not a question. This is just illustrative. My brother is in the barbecue business. He runs a successful chain of barbecue restaurants. And he said to me not too long ago, he said, I finally determined, if people can't afford to buy barbecue, it doesn't matter what my tax rate is.

And I think that in terms of the analysis of what we should be concerned about is giving people the money to spend, creating the demand side is much more important than giving breaks to businesses which, in many cases, will not use them to create jobs, will use them to pay off debt or sit on the sidelines until conditions improve.

So I throw that out just as an anecdote that may or may not be of value.

Mr. ELMENDORF. Thank you, Congressman.

Mr. YARMUTH. Thank you for your testimony. I yield back.

Chairman SPRATT. Mr. Elmendorf, this is the conclusion of your part of our hearing. We very much appreciate your thorough and thoughtful answers, as patiently delivered as they have been painstaking. I think this all goes well for our working relationship in the future. Thank you very much indeed.

To our other witnesses, we beg your indulgence until we can once again get the full committee together. We will go with the second panel at that time. In the meantime, you are welcome to use the anteroom just behind me to relax, to have a sandwich, if you would like, or use the telephone. We will start back up somewhere around 1:15.

Mr. ELMENDORF. Thank you, Mr. Chairman. I look forward to being back before you again soon.

Chairman SPRATT. It won't be long. Thank you very much indeed for your excellent testimony.

[Whereupon, at 12:30 p.m., the committee was recessed, to reconvene at 1:15 p.m.]

Chairman SPRATT. We will now turn to our second panel. We are still waiting for the Republican members to come back from their hearing or meeting with the President, and we are still rounding up some Democrats, but we think it is important that we get under way and not ask our second panel to forbear any longer.

Once again, let me invite all four of you here.

Dr. Alice Rivlin, as I noted earlier, was the founder, present at the creation of the Congressional Budget Office. She served as OMB Director under President Clinton. She is presently at Brookings.

We will also hear from Dr. Mark Zandi, who is the Chief Economist and cofounder of Moody's Economy.com; and from Dr. Laurence Meyer, former member of the Board of Governors of the Federal Reserve and currently Vice Chairman of the Macroeconomic Advisers; and Dr. Kevin Hassett, Resident Scholar and Director of Economic Studies at the American Enterprise Institute.

STATEMENTS OF ALICE M. RIVLIN, PH.D., SENIOR FELLOW, THE BROOKINGS INSTITUTION; MARK ZANDI, PH.D., CHIEF ECONOMIST AND COFOUNDER, MOODY'S ECONOMY.COM; LAURENCE MEYER, PH.D., VICE CHAIRMAN, MACRO-ECONOMIC ADVISERS, LLC; AND KEVIN A. HASSETT, PH.D., SENIOR FELLOW AND DIRECTOR OF ECONOMIC POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE

Chairman SPRATT. By common consent, we have agreed that Dr. Rivlin will go first.

Welcome again to the Budget Committee. How many times you have testified, I don't know, but we always come away wiser and better informed because of your contribution. So the floor is yours, and we look forward to your testimony.

STATEMENT OF ALICE M. RIVLIN, PH.D.

Ms. RIVLIN. Thank you, Mr. Chairman. I am very pleased to be back here. I always enjoy coming before this committee.

I will summarize my testimony fairly briefly, since we don't have a lot of time. But I would like to emphasize some points that we have not talked about, particularly the long-run budget deficits that are looming ahead of us and what I see as the opportunity for the Congress as they act on the stimulus to also take action on the long-run budget deficits at the same time.

On the outlook, the risks, it seems to me, are on the downside. You are going to hear from modelers who are more expert in running the models than I am, and you have already heard from Doug Elmendorf. But I think it is important to keep in mind that there is just enormous uncertainty at the moment and I think three reasons, at least three reasons, not only for their being a great deal of uncertainty but for the risks being mainly on the downside.

One is that the financial system is still not stable. The models that people use to make forecasts have been calibrated on what has happened in the ups and downs of the economy over the last several decades since World War II. But in that period we have not had a recession in which the cause was a financial meltdown. So what you get from models is the answer to the question here is what we think will happen under these current circumstances if the financial system is operating normally, and we know that ours is not.

Second point, we don't want to get back to the overspending and over-borrowing economy that brought us to this path. We have been living beyond our means. We must be aspiring to a new, normal economy in which there is less consumption and more saving and less dependence on foreign borrowing. That will give us a more stable long-term situation, but it will make it harder to climb out of this recession.

Finally, I am concerned about the impact of the very rapid increases in the U.S. debt on willingness of our creditors, especially our foreign creditors to keep buying Treasury securities. They are buying them now because there is nothing else to buy, and we are the most secure place to put their money. But I think we have to worry as the world economy recovers about the magnitude of the debt that we are pushing out there.

Now, I would like to make a distinction which has been lost in recent times between a stimulus and an investment plan. I think we need both. We need in this quite dire situation a stimulus that is, as we used to say, targeted, temporary and spends out quickly. And there is much in H.R. 1 that is of that nature: cash to low and moderate income people, aid to the States, temporary appropriations for genuinely shovel-ready projects. All of that I think could spend out quite quickly.

But we also need, in my opinion, a longer-run, very well-thought-out investment in public infrastructure and in the skills and capabilities of our economy. That ought not to be just shoved into a quick stimulus. It should be very well thought out. It should include transportation projects, mass transit particularly, communications projects, I think health information technology especially, and a heavy emphasis on improving the skills of the workforce.

We need all of that to grow our economy and to be more productive in the future. But we need to plan it well, and I think over time we need to pay for it. What we need is a shift of resources from somewhere else into more public investment, which we have neglected for a long time. We don't need to worry right now where the resources are going to come from, but if this is a well-planned long program over time we are, with any luck, going to get back to fuller employment, and we will need to worry about that. So the resources can only come from reducing other government spending or from additional taxes. That should not be forgotten.

I believe that we have a serious—much more serious than we are remembering now—problem of long-term deficits built into our budget for reasons that are familiar. We have spending projections rising very rapidly, faster than the GDP will grow, faster than revenues at any set of tax rates, coming from the principal entitlement programs, especially Medicare and Medicaid and, to a lesser extent, Social Security. That used to be very far in the future. It is not anymore. It is beginning now and that spending will rise; and, for that reason, I think we have to now, while we have the chance, take actions that will bring down those deficits in the future.

You could fix Social Security right now. It wouldn't hurt the current economy. Nobody is going to do it by cutting benefits for people who are already retired. But if you did something like was done in 1983, a package of Social Security reforms enacted now that could include raising the retirement age gradually in the future, indexing it to longevity, changing the indexing so that benefits do not go up as rapidly, especially for high-income people, raising the cap to which taxes apply. A package of things like that enacted now could reassure the world that we are putting our financial house in order for the future and not do any concurrent damage.

Medical care is harder, but it is not impossible. If the Congress were to take seriously the mandate to make Medicare more efficient and put in place the data collection and the changes in incentives that would make this program more cost-effective over time, this is the time to do it, because it takes some upfront investment and the payoff is long term.

Finally, process reform. I know this committee has been over time committed to caps and to PAYGO. I would encourage you to stay committed, not to make too many exceptions. But in the long run, that is not enough. That will keep the deficits from getting worse, and the getting worse is already built in. So I think the Congress is going to need to shift to some new budget process that will put entitlements and taxes into a long-run structure so that you can actually decide—you are forced to actually decide on the magnitude of the long-term deficits and take steps to keep the budget in the range in which you want it.

Thank you, Mr. Chairman.

Chairman SPRATT. Thank you.

[The prepared statement of Alice Rivlin follows:]

PREPARED STATEMENT OF ALICE M. RIVLIN,* THE BROOKINGS INSTITUTION AND GEORGETOWN UNIVERSITY

Mr. Chairman and members of the Committee: It is a pleasure for me to be back at the House Budget Committee. I am especially gratified to follow my former colleague, Douglas Elmendorf, as he makes the first of many appearances before this Committee as Director of the Congressional Budget Office.

I will say a few words about the uncertainties of the economic outlook and then turn to the question of how to deal with the immediate and longer-run challenges of fiscal policy. The challenge of budget-making has never been greater. Indeed, I believe that the future viability of the United States economy depends very heavily on budget policy-makers' ability to focus on two seemingly contradictory imperatives at the same time:

- The immediate need to take actions which will mitigate the impact of the recession and help the economy recover—actions that necessarily require big increases in the budget deficit
- The equally urgent need to take actions that will restore fiscal responsibility and reassure our creditors that we are getting our fiscal house in order—actions to bring future deficits down.

I stress two sets of actions because I do not believe it will be sufficient to pay lip service to the long run challenge, while acting only on deficit-increasing responses to the current financial and economic crisis. Congress and the Administration must work together on actual solutions to both problems at the same time.

THE ECONOMIC OUTLOOK

We meet at a time of extraordinary uncertainty about how deep the recession will be and how long it will last. Forecasters all admit that they have little confidence in their ability to predict how consumers, producers, and investors at home and abroad will react to the cataclysmic economic events that have occurred. But people in the forecasting business still have to produce forecasts, so they do the best they can. The Congressional Budget Office (CBO) forecasts that the recession will "last well into 2009" and that the economy will begin to recover, albeit slowly, in 2010. CBO expects unemployment to peak at about 9 percent. The CBO is a bit more pessimistic than the Blue Chip average of commercial forecasters, because the rules of CBO forecasting do not allow them to take account of likely congressional actions to stimulate the economy and enhance recovery.

Right now I think we should be skeptical of all forecasts and especially conscious of the risk that things may continue to go worse than expected. The current CBO forecast is much more pessimistic than the one released just last September, and the Blue Chip consensus has been going steadily south for many months. Additional revelations of weakness in the financial services sector could further impede credit flows and produce a continued slide in all forecasters' expectations.

Indeed, uncertainty about the health of the financial sector compromises all current forecasting efforts. The economic models used by forecasters are based on the experience of the post World War II period, especially the last several decades. Not since the 1930's, however, have we experienced a downturn caused by crisis in the financial sector. Despite aggressive efforts of the Treasury and the Federal Reserve to stabilize the financial sector, credit is not flowing normally, even to credit- worthy borrowers. Continued instability in the financial sector and credit tightness could deepen the recession and delay recovery.

*The views expressed in this testimony are those of the author and should not be attributed to the staff, officers or trustees of the Brookings Institution or Georgetown University.

Also adding to the uncertainty and increasing the chance that recovery will be unusually slow is the fact that returning to the pre-crisis economy is not desirable. Before the current crisis Americans were consuming and borrowing too much, while saving too little. We had become an over-mortgaged, over-leveraged society dependent on the inflow of foreign credit. If recovery from this recession is to be solid and sustainable, we must stop living beyond our means. We must transform ourselves into a society that consumes less, saves more and finances a larger fraction of its investment with domestic saving, rather than foreign borrowing. This transformation is necessary, but it will put recovery on a slower track.

Indeed, not since we were a developing country have we been so dependent on foreign creditors. We are lucky that, even though this world-wide financial crisis started in the United States, the response of world investors has been to flock to the safety of U.S. Treasuries, which makes it possible for our government to borrow short-term at astonishingly low rates. But we cannot count on these favorable borrowing conditions continuing forever. Especially if we fail to take serious steps to bring down future budget deficits, the United States Government could lose the confidence of its foreign creditors and be forced to pay much higher interest rates on to finance both public debt and private debt. Rapid increases in interest rates and a plummeting dollar could deepen the recession and slow recovery.

AN "ANTI-RECESSION PACKAGE" AND INVESTMENT IN FUTURE GROWTH

Despite the uncertainty of forecasts it is already clear that this recession is bad and that worse is yet to come. Recessions always increase budget deficits as revenues drop and recession-related spending increases. These automatic deficits help stabilize the economy. In addition, since an unusually severe downturn in the economy is threatening, the government should act quickly to mitigate the downslide with spending increases and revenue cuts that will stimulate consumer and investor spending, create jobs and protect the most vulnerable from the ravages of recession.

What we used to call "stimulus" (temporary spending or tax relief designed to jump-start the economy) has been merged into a broader concept of "recovery" and investment in future growth. However, I believe an important distinction should be made between a short-term "anti-recession package" (aka "stimulus ") and a more permanent shift of resources into public investment in future growth. We need both. The first priority is an "anti-recession package" that can be both enacted and spent quickly, will create and preserve jobs in the near-term, and not add significantly to long run deficits. It should include temporary aid to states in the form of an increased Medicaid match and block grants for education and other purposes. Aiding states will prevent them from taking actions to balance their budgets—cutting spending and raising taxes—that will make the recession worse. The package should also include temporary funding for state and local governments to enable them to move ahead quickly with genuinely "shovel ready" infrastructure projects (including repairs) that will employ workers soon and improve public facilities. Another important element of the anti-recession package should be substantial transfers to lower and middle income people, because they need the money and will spend it quickly. This objective would be served by increasing the Supplemental Nutrition Assistance Program (SNAP), unemployment compensation, and the Earned Income Tax Credit. Helping people who lose their jobs to keep their health insurance and aiding distressed homeowners also belong in this "anti-recession" package. On the tax side, my favorite vehicle would be a payroll tax holiday, because payroll tax is paid by all workers and is far more significant than the income tax for people in the lower half of the income distribution. Moreover, a payroll tax holiday would be relatively easy to reverse when tax relief was no longer appropriate. This anti-recession package should move forward quickly. Because its components would be temporary, there would be little reason for concern about its impact on the deficit three or four years down the road.

The anti recession package should be distinguished from longer-run investments needed to enhance the future growth and productivity of the economy. The distinction is not that these longer-run investments are less needed or less urgent. We have neglected our public infrastructure for far too long and invested too little in the skills of the future workforce. If our economy is to grow sustainably in the future we need to modernize our transportation system to make it more efficient and less reliant on fossil fuels. We need to assure access to modern communications across the country and invest in the information technology and data analysis needed to make medical care delivery more efficient and effective. We need a well thought-out program of investment in workforce skills, early childhood education, post-secondary education, science and technology. Such a long-term investment program should not be put together hastily and lumped in with the anti-recession package. The elements of the investment program must be carefully planned and will not create many jobs right away.

Since a sustained program of public investment in productivity-enhancing skills and infrastructure will add to federal spending for many years, it must be paid for and not simply added to already huge projected long-term deficits. That means either shifting spending from less productive uses or finding more revenue. Overtime, Congress could reduce commitments to defense programs and weapons systems that reflect outmoded thinking about threats to U.S. security, reduce agricultural subsidies, and eliminate many small programs that have outlived their original priorities. Reform of the tax system—including making the income tax simpler and fairer or increasing reliance on consumer taxation—could produce more revenue with less drag on economic growth. None of these policies would be easy, but the resources to pay for large permanent increases in federal spending must be shifted from somewhere else as the economy returns to full employment. Congress will only be able to accomplish this reallocation of resources if it reinstates some form of long run (say, ten year) PAYGO and caps on discretionary spending.

I understand the reasons for lumping together the anti-recession and investment packages into one big bill that can pass quickly in this emergency. A large combined package will get attention and help restore confidence that the federal government is taking action—even if part the money spends out slowly. But there are two kinds of risks in combining the two objectives. One is that money will be wasted because the investment elements were not carefully crafted. The other is that it will be harder to return to fiscal discipline as the economy recovers if the longer run spending is not offset by reductions or new revenues.

IMMEDIATE ACTION TO BRING DOWN FUTURE DEFICITS

As this Committee knows well, projections of the federal budget show rapidly rising spending over the next several decades attributable to three major entitlement programs; namely, Medicare, Medicaid and Social Security. Under current rules, Social Security spending will rise rapidly over the next two decades, but level off after the Baby Boom generation passes through the system. The health care entitlements are expected to rise even faster. Moreover, they are expected to keep on rising because they are dominated by continued increases in the spending for health care in both the public and private sectors. If policies are not changed Medicare and Medicaid—and to a lesser extent Social Security—will drive federal spending up considerably faster than the rate at which the economy is likely to grow. Unless Americans consent to tax burdens that rise as fast as spending, a widening gap will open up. We will not be able to finance these continuously growing deficits.

Because rapidly rising debt threaten our credibility as sound fiscal managers, we do not have the luxury of waiting until the economy recovers before taking actions to bring down projected future deficits. Congress and the Administration should take actual steps this year to reduce those deficits in order to demonstrate clearly that we are capable of putting our fiscal house in order. This can be done without endangering economic recovery.

The crisis may have made Social Security less of a political “third rail” and provided an opportunity to put the system on a sound fiscal basis for the foreseeable future. Fixing Social Security is a relatively easy technical problem. It will take some combination of several much-discussed marginal changes: raising the retirement age gradually in the future (and then indexing it to longevity), raising the cap on the payroll tax, fixing the COLA, and modifying the indexing of initial benefits so they grow more slowly for more affluent people. In view of the collapse of market values, no one is likely to argue seriously for diverting existing revenues to private accounts, so the opportunity to craft a compromise is much greater than it was a few years ago. Fixing Social Security would be a confidence building achievement for bi-partisan cooperation and would enhance our reputation for fiscal prudence.

Vigorous action should also be taken to make Medicare more cost effective and slow the rate of growth of Medicare spending, which contributes so much to projected deficits. While restraining health spending growth should be a major feature of comprehensive health reform, Medicare is an ideal place to start the effort. Medicare is the largest payer for health services and should play a leadership role in collecting information on the cost and effectiveness of alternative treatments and ways of delivering services, and designing reimbursement incentives to reward effectiveness and discourage waste. Congress has a history of allowing pressure from providers and suppliers (for example, suppliers of durable medical equipment or pharmaceutical companies) to thwart efforts to contain Medicare costs. The government has also not been adequately attentive to punishing and preventing Medicare fraud. The United States will not stand a chance of restoring fiscal responsibility at the federal level unless Congress develops the political will to hold health providers accountable—whether in the context of existing federal programs or comprehensive health reform—for delivering more cost effective care. A good place to start is Medicare.

PROCESS REFORM

This Committee does not need to be convinced that deficits matter and that the deficits looming in the federal budget—exacerbated by the rapid increases in debt associated with recession and financial bailout—must be dealt with sooner rather than later. You know that procrastination will make the hard choices harder and make us increasingly dependent on our foreign creditors and exposed to their policy priorities. The question is: should you take actual steps now to reduce future deficits or design process reforms that will force you to confront viable options and make choices in the future? My answer is: do both.

Fixing Social Security and taking aggressive steps to control the growth of Medicare costs would be visible evidence that Congress and the new Administration have the courage to rein in future deficits. But the Congress also needs to restore discipline to the budget process—not use recession or the financial meltdown as excuses for throwing fiscal responsibility to the winds just when we are going to need it more than ever. A large temporary anti-recession package is the right fiscal policy in the face of severe recession and should not be subject to offsets—that would defeat the purpose. But more permanent investments in future growth—also good policy—should be paid for and not allowed to add to future deficits. Caps on discretionary spending and PAYGO for revenues and mandatory spending should be reinstated and seriously enforced.

Moreover, PAYGO is not enough, because it only guarantees that congressional actions with respect to entitlements and revenues will not make projected deficits worse than they would be under current policies. But, we all know that deficits projected under current policy will rise at unsustainable rates. Spending required by Medicare, Medicaid and Social Security will rise substantially faster than revenues at any feasible set of tax rates. We will not be able to borrow that much money—even if we thought it desirable to do so.

The current budget process subjects a declining—discretionary spending—to annual scrutiny by leaves entitlement programs and revenues on automatic pilot outside the budget process. Fiscal responsibility requires that all long-term spending commitments be subject to periodic review along with taxes and tax expenditures. There is no compelling logic for applying caps and intense annual scrutiny to discretionary spending, while leaving huge spending commitments, such as Medicare or the home mortgage deduction entirely outside the budget process and not subject to review on a regular basis. I am a member of a bipartisan group called the Fiscal Seminar (sponsored by The Brookings Institution and the Heritage Foundation) that addressed this problem in a paper entitled, Taking back our Fiscal Future, in 2008. We may not have come up with the right solution, but we certainly identified a serious problem that stands in the way of getting the federal budget on a sustainable long run track.

NOT A PARTISAN MATTER

The challenges that face this Committee—mitigating the recession, enhancing future growth, restoring sustainable fiscal responsibility—cannot be solved by one political party, but require non partisan analysis and bipartisan cooperation. Many budget analysts with quite disparate views on particular policies share the conviction that Congress and the Administration must meet the double challenge of reviving the economy and restoring fiscal responsibility at the same time. I attach a memo to President Obama signed by twelve experienced budget analysts (including myself) that emphasizes these points.

Thank you, Mr. Chairman and members of the Committee.

ATTACHMENT

January 22, 2009.

TO: *President Obama*

FROM: *Bob Bixby, William Galston, Ron Haskins, Julia Isaacs, Maya MacGuineas, Will Marshall, Pietro Nivola, Rudy Penner, Robert Reischauer, Alice Rivlin, Isabel Sawhill, Eugene Steuerle*

SUBJECT: *A Budget We Can Believe In*

Your first budget will be a defining document. It will cast the basic mold of your administration, highlight your key priorities, and specify how you are going to deliver on your most important campaign promises or modify them in light of new developments. The decisions you make in shaping this budget will be among the most consequential of your tenure.

In our view, the overriding imperative for your first budget is to strike a judicious balance between America's short-term and long-term economic needs. To accomplish this, that budget must be strategic as well as tactical. The steps you take to address our short-term problems must not make it harder to achieve our long-term goals. Indeed, they should set the stage both for steady economic growth and a sustainable fiscal future. To be a truly transformative president, you must not allow the urgency of the short-term to crowd out concern for the country's long-term wellbeing.

As you have noted, the key short-term challenges are:

- stabilizing America's financial markets to ensure an ample and affordable supply of credit, which is the lifeblood of our economy; and
- reducing the severity and duration of the current recession and getting Americans back to work.

At the same time, your budget must set in motion measures that deal with two critical long-term challenges to America's economic health:

- controlling the growth of health costs and putting Social Security on a financially sustainable path.
- reforming America's tax system to make it more efficient, fairer and simpler and to raise adequate revenue while maintaining economic growth.

These short- and long-term economic imperatives are inextricably linked. The costs of stabilizing the financial markets and stimulating economic growth will generate a large increase in our national debt. We will have to borrow money in domestic and international capital markets to finance this debt, and without a serious commitment to long-term fiscal restraint, lenders will eventually question the nation's fiscal credibility. They may respond by reducing the share of their portfolios devoted to U.S. government debt or by charging higher interest rates. In the extreme, the reluctance to buy U. S. debt could cause a crisis in international capital markets. No one can describe the risks precisely, but Wall Street's recent troubles demonstrate that the perils of over reliance on debt can come swiftly and in unpredictable ways. What is predictable is that if the long-term problem is not confronted, interest costs will absorb a growing proportion of our budgetary resources and, together with growing health costs and Social Security, will threaten to crowd out spending on programs for the poor, children, and improving the nation's infrastructure. Moreover, our dependence on foreign creditors and the resulting mortgage on future national incomes will diminish American standards of living for generations to come.

We understand full well the myriad considerations that will shape your fiscal proposals for the next fiscal year. We suggest, however, two criteria that a future-oriented budget for fiscal 2010 should meet.

- First, you have pledged repeatedly to scrub every line item in the current budget with an eye to finding items that are either ineffective or outdated. We do not believe that this effort will be credible unless it produces significant savings from both programs and tax expenditures.
- Second, the stimulus package should not worsen the long-term fiscal outlook. To the extent that it includes items that increase the long-term budget deficit, offsetting long-term spending cuts or revenue streams should be proposed.

We believe, moreover, that Congress must re-impose caps on discretionary spending as soon as the economy begins to recover from the recession. The budget documents you submit to Congress should make it clear that you will support such a move.

The long-term budget challenge can be stated succinctly. Three large programs—Social Security, Medicare, and Medicaid—now constitute almost one-half of non-interest federal spending and are growing faster than tax revenues because of soaring health costs and the aging of the population. If we fail to reform these spending programs and insist on maintaining the tax burden where it is has been over the past 50 years (about 18 percent of GDP), deficits will soar, and the public debt is likely to exceed 100 percent of the GDP within 25 years. That compares to 37 percent at the end of fiscal 2007.

It's entirely understandable that public concern over the long-term budget problem has now been swamped by the financial crisis and accompanying recession. But as President you can't afford to lose sight of these inconvenient truths. The budget deficit for fiscal 2009 is estimated at $1.2 trillion by CBO, and this excludes any new spending as part of a stimulus bill. The federal debt owed to the public may increase by considerably more than 50 percent over the next two years. Although large debt increases occurred in the early 1980s, they did not occur as quickly. Moreover, there are two important differences from that era. First, we are now more dependent on foreign private and government investors to buy our debt. Second, relative to the size of the economy (GDP), Social Security, Medicare, and Medicaid are much larger now than they were then, and they are expected to grow more rapidly as the oldest baby boomers begin to retire. Consequently, the budget deficit will contract more slowly than usual as the economy recovers.

Although we are rightly absorbed by our short-term problems, the long-term budget situation ultimately poses graver challenges to the success of your presidency. Social Security, Medicare, and Medicaid are expected to constitute 1.8 percent more of the GDP in 2016 than they did in 2008. That may not sound like much, but if the growth were to be financed entirely with tax increases, it would imply an overall tax increase of almost 10 percent above historical levels—and that would only be the first of many tax increases to follow. If it were financed by cutting all other non-interest programs including defense, the across-the-board reduction would have to be more than 20 percent compared to baseline levels. Even if a number of inefficient and low priority programs are eliminated, it would not be possible to fulfill your election promises—to expand health insurance coverage or to increase public investment in education, infrastructure, and research on alternative energy sources, among many others—without digging our long-term fiscal hole even deeper.

Your budget should make it very clear that you take the long-term budget problem seriously. It must quantify the cost of our long-term promises and explicitly state the goal of achieving fiscal sustainability. As a first step, we should stabilize the ratio of debt to GDP while creating an atmosphere conducive to economic growth. The budget could, for illustrative purposes, specify two or three combinations of target revenue and spending paths that would achieve this initial goal.

We believe you should do more than express your concern about the danger of escalating future deficits. You should move quickly to reduce them without endangering near-term economic recovery. First, you should give high priority to putting Social Security on a sound fiscal basis to reduce future deficits and show our creditors that we are taking serious steps to manage our national finances. Second, you should take quick action to reduce the growth of Medicare by shifting to payment systems that reward effective treatments and discourage wasteful spending.

The long-term fiscal problem is complicated by the fact that it is difficult to contemplate increased revenues being part of the solution so long as the public rightly remains highly distrustful of our inequitable and economically inefficient tax system. Tax reform is always difficult, but it will be necessary to achieve a rational solution to our long-term problems. Hundreds of billions of dollars worth of tax expenditures in the federal code must be evaluated and eliminated where they inhibit economic growth, are inefficient, have undesirable distributional consequences, or are difficult to administer.

Throughout your campaign, you pioneered new ways of involving the American people in our nation's political life, and you have signaled your determination to continue that commitment as president. Our long-term economic and fiscal future is an issue that cries out for just such public engagement. Congress is unlikely to cooperate in undertaking such painful reforms so long as the general public remains unaware of the magnitude and urgency of the long-term fiscal challenge. Therefore, we recommend that you launch an intensive public education campaign. This could include a series of town hall meetings across the country or fireside chats to explain the problem and lay out options for solving it to the American public. Although you could send surrogates around the country, you should personally take part in some of these meetings to underscore their vital importance, as President Clinton did a decade ago. If Americans grasp how essential budget reform is for the wellbeing of their children and grandchildren, they will be more likely to accept the sacrifices necessary to get the budget under control.

One additional (and crucial) point: it makes no sense to undertake a challenge of such magnitude unless it yields structural changes that are enduring. To that end, we recommend two key shifts in our budget procedures.

- Once an agreement for tax and long-term spending reform is in place, it must be enforced by pay-as-you-go rules that require that all tax cuts or entitlement increases be financed by some combination of tax increases and entitlement cuts. Without such rules, a painfully negotiated agreement is likely to erode over time.
- In addition, targets for entitlement spending and tax expenditures should be budgeted for the long run, say, 30 years. If unexpected events push spending or tax expenditures above targets, automatic triggers could be used to slow spending growth, increase revenues, or some combination of the two.

We have outlined a formidable task. It may be possible to muddle through another eight years without facing the long-term challenge. To evade it, however, would be to squander an historic opportunity to set our economy and governing institutions on a sound and sustainable course. To be remembered as a truly transformative president, you must boldly confront—and master—the toughest problems of your time.

The signatories to this memo are all members of a group that has been meeting together for several years at the Brookings Institution under the auspices of Brookings and the Heritage Foundation. The views expressed are those of the individuals involved and should not be interpreted as representing the views of their respective institutions.

Chairman SPRATT. Now let's go to Dr. Zandi, and let me say that there are some votes coming up on the floor. We are going to finish this one way or the other. We want every witness to have an opportunity to be on the record.

STATEMENT OF MARK ZANDI, PH.D.

Mr. ZANDI. I will keep it to 2 hours. I will stick to that. Yes, sir.

Thank you, Mr. Chairman for the opportunity and members of the committee. I am an employee of the Moody's Corporation, but these are my own personal views.

I will make six points.

First, the near-term economic outcome is grim. The economy has lost 2.6 million jobs over the past year. I think it is very possible we lose just as many jobs in the first half of 2009. The unemployment rate is 7.2 percent. It will easily be over 9 percent by the end of the year. And the downturn has engulfed every industry, every occupation and every corner of the country, which is the hallmark of this downturn. It is the breadth of the downturn.

Consumer spending has collapsed, business investment is down, exports are falling. The only source of growth at the current point in time is government spending.

So, first point, the outlook is very dark.

The second point is that this dark economic outlook is dependent on policymakers doing three broad things very quickly in the next few weeks:

First, to stabilize the teetering financial system, some of the remaining TARP money should be used to purchase and then guarantee troubled assets. This is important to getting the assets off the balance sheets of these institutions and also establishing a market for these assets which is necessary to get private capital back into the financial system.

Second, the TARP money should be used for a very large foreclosure mitigation plan which includes mortgage modifications with writedowns. We have learned that modifications that only include rate reductions and term extensions are not working. There is a very high redefault rate. So we need writedowns.

Third and most importantly and most immediately, I think it is key for policymakers to implement a very aggressive fiscal stimulus plan. Increased government spending and tax cuts are necessary to fill the void left by slumping private economic activity.

Third point, the House Democratic fiscal stimulus plan which includes $825 billion in stimulus will not reverse the downturn, but it will provide a very vital boost to a flagging economy. By my estimates, with this stimulus there will be approximately 3 million more jobs; and the jobless rate will be 1.5 percentage points lower by the end of 2010 than without any fiscal stimulus. Without stimulus, the unemployment rate will rise well into the double digits and the economy will not return to full employment, which by my estimate is a 5 percent unemployment rate, until 2014. So very vital to pass the stimulus plan.

Point four, the economic benefit of the House plan depends on how quickly the government spending can occur. Of course, the recent CBO analysis says the spend-out rates can take years. If the past is indeed prologue, and I think much of their analysis is based on past historical experience, then I am overestimating the benefits of the House plan. Policymakers should therefore fund projects that can be implemented quickly and should also establish mechanisms that will provide the necessary oversight to ensure that the projects are conducted in a timely fashion.

Point five, policymakers may also want to consider expanding the size of the stimulus. I don't think $825 billion is enough, and I would increase the size of the package by including more tax cuts. Tax cuts do not have the same economic bang for the buck as increased government spending. Some of the tax cuts will be saved, some of it will be used to repay debt, not bad things but not good for the economy in the very near term, and some of it will be used for the purchase of imported goods that don't help jobs here in the United States. But they can get into the economy quickly, quickly in 2009.

Two proposals, a refundable tax credit for a home purchased in 2009, payable at the time of the purchase, would be an effective way to help stimulate home sales and work off some of the mountain of inventory. In the current plan, there is a tax credit, but it is only for first-time home buyers. I would make it for all home buyers, and I would make the credit payable at the sale so they could be used for the down payment to facilitate sales.

The second proposal, a payroll tax holiday for the entire third quarter of this year for both employees and employers. If you did that, it would be a tremendous boost to lower and middle income households and most critically to small businesses, many of whom are going to fail in this economy if they don't get immediate help.

The cost of these two proposals would bring the total cost of the House plan to just over $1 trillion, which I think is more consistent with the severity of the situation that we are in.

Point six, final point, there are very reasonable concerns that the cost of all the actions policymakers are taking to quell a crisis will overwhelm the government's resources and further exacerbate the Nation's daunting long-term fiscal challenges. There is no doubt that the Federal debt will rise substantially. Doug Elmendorf pointed out that the debt to GDP ratio is 40 percent. I think a reasonable forecast is when this is all said and done it will be 60 percent. It is important to consider, however, that the Nation's budgetary problems would likely be even worse if policymakers do not respond aggressively to the crisis, as a sliding economy would undermine tax revenues and result in much higher government outlays.

Moreover, while running massive deficits are very undesirable, the resulting debt load is still manageable. Sixty percent is still very manageable. Global investors are fully expecting and remain very avid buyers of our Treasury debt, in part because the U.S. economy remains the global economy's triple A credit. For the U.S to maintain its financial standing, however, policymakers must immediately begin to address the Nation's long-term fiscal challenges.

Let me say in conclusion that any fiscal stimulus plan in my view is more than dollars and cents. It has to be effective in lifting spirits. Confidence hit a new all-time record low in the month of January. A confidence report survey for January came out this morning. It hit an all-time new record low.

So the stimulus has to be passed very quickly and, most importantly, has to be explained very clearly so that households and businesses are convinced that it is going to work. Unless the plan helps dissipate the current dark mood of pessimism, it will do little to stem the current economic downturn.

Thank you.

Chairman SPRATT. Thank you very much.

[The prepared statement of Mark Zandi follows:]

PREPARED STATEMENT OF MARK ZANDI, CHIEF ECONOMIST AND COFOUNDER, MOODY'S ECONOMY.COM

Mr. Chairman and members of the committee, thank you for the opportunity to testify on such an important matter in a time of economic and financial crisis. I am an employee of the Moody's Corporation, but my remarks today reflect my personal views.

I will make six points this morning:

1. The near-term economic outlook is grim. The economy has already lost 2.6 million jobs since the current downturn began and will lose about as many more during the first half of this year. Unemployment, which is now at 7.2%, will rise to nearly 9% by year's end. The downturn will engulf nearly every industry, occupation and region of the country. Consumer spending has collapsed, business investment is declining, and exports are now falling, as the entire global economy is suffering a synchronized downturn.

2. Even this dark economic outlook requires that policymakers take three broad actions in the next few weeks. First, to stabilize the still-teetering financial system, some of the remaining TARP money should be used to purchase and guarantee troubled assets on the system's balance sheet. Second, the TARP money should also be used to fund an aggressive foreclosure mitigation plan that includes mortgage write-downs. Without such a plan, foreclosures will continue to surge, further undermining the financial system and broader economy. And third, policymakers must implement an aggressive fiscal stimulus plan. Increased government spending and tax cuts are necessary to fill the void left by slumping private economic activity.

3. The House Democratic fiscal stimulus plan, which includes some $825 billion in stimulus measures, will not reverse the economic downturn, but it will provide a vital boost to the flagging economy if passed quickly. With the stimulus, there will approximately 3 million more jobs, and the jobless rate will be 1.5 percentage points lower by the end of 2010 than without any fiscal stimulus. Without a stimulus, unemployment will rise well into the double digits by this time next year, and the economy will not return to full employment until 2014.

4. The economic benefit of the House plan critically depends on how quickly the government spending can occur. A recent Congressional Budget Office analysis shows that historical spend-out rates on such outlays can take years. If past is indeed prologue, then I am measurably overestimating the economic benefit of the House plan. Policymakers should therefore fund projects that can be implemented quickly and should also establish mechanisms that will provide the oversight necessary to ensure that the projects are conducted in a timely fashion.

5. Policymakers may also want to consider expanding the size of the stimulus package with more tax cuts. Tax cuts do not have the same economic bang for the buck as increased government spending, as households will save some of the tax cuts or use them to repay debt or purchase imported goods, but tax cuts can get into the economy quickly. A refundable tax credit for a home purchased in 2009, payable at the time of the purchase, would quickly stimulate home sales and reduce the mountain of unsold homes weighing on house prices and exacerbating foreclosures and the crisis in the financial system. A payroll tax holiday for employees and employers in, say, the third quarter of this year would also provide a large boost to lower- and middle-income households and struggling small businesses.

These two tax cuts would bring the total cost of the House plan to just over $1 trillion.

6. There are very reasonable concerns that the cost of all the actions policymakers are taking to quell the crisis will overwhelm the government's resources and exacerbate the nation's daunting long-term budget challenges. There is no doubt that the federal debt load will rise substantially as a result, from about 40% of GDP now to as much as 60% of GDP, as the budget deficit this year and next will collectively total several trillion dollars. It is important to consider, however, that the nation's budgetary problems will likely become even worse if policymakers do not respond aggressively to the crisis, because the sliding economy would undermine tax revenues and result in much higher government outlays. Moreover, although running massive deficits is highly undesirable, the resulting debt load is still manageable. Global investors are fully expecting this and remain avid buyers of Treasury debt, in part because there is little private sector borrowing at this time and in part because the U.S. remains the global economy's Aaa credit. Reflecting this, Treasury yields remain near record lows. For the U.S. to maintain its financial standing, however, policymakers must immediately begin to address the nation's long-term fiscal challenges.

I will conclude by saying that any fiscal stimulus plan has to be about more than dollars and cents to be effective in lifting spirits and the economy. It must be passed quickly and explained clearly so that households and businesses are convinced it will work. Unless the plan helps dissipate the dark mood, it will do little to stem the economic downturn.

[The supplemental statement of Mr. Zandi follows:]

SUPPLEMENTAL STATEMENT OF MARK ZANDI, CHIEF ECONOMIST AND COFOUNDER, MOODY'S ECONOMY.COM

Mr. Chairman and members of the committee, my name is Mark Zandi; I am the chief economist and cofounder of Moody's Economy.com.

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The new administration and Congress are working to implement a large fiscal stimulus plan to mitigate the severe economic downturn. The latest step in this effort is the plan put forth by House Democrats in mid-January. As laid out in the American Recovery and Reinvestment Act, the plan would cost $825 billion and include a large number of spending increases and tax cuts.[i] The national, industry and state economic impact of this stimulus plan are assessed in the following analysis.

The House stimulus plan will not reverse the current downturn, but it will provide a vital boost to the flagging economy. With the stimulus, there will be 3 million more jobs and the jobless rate will be more than 1.5 percentage points lower by the end of 2010 than without any fiscal stimulus. Without a stimulus, unemployment will rise well into the double digits by this time next year, and the economy will not return to full employment until 2014.

The economic benefit of the House plan critically depends on how quickly the government spending can occur. A recent Congressional Budget Office analysis shows that historical spend-out rates on such outlays can take years. If past is indeed prologue, this analysis is overstating the economic benefits of the House plan. Policymakers should therefore fund projects that can be implemented quickly and should also establish mechanisms that will provide the oversight necessary to ensure that the projects are executed in a timely fashion.

Policymakers may also want to consider expanding the size of the stimulus package with more tax cuts. Tax cuts do not have the same economic bang for the buck as increased government spending, as households will save some of the tax cuts or use them to repay debt, and purchase imported goods, but tax cuts can get into the economy quickly. A refundable tax credit for a home purchased in 2009, payable at the time of the purchase, would be an effective way to quickly stimulate home sales and reduce the mountain of unsold homes weighing on house prices and exacerbating foreclosures and the crisis in the financial system. A payroll tax holiday for employees and employers in, say, the third quarter of this year would also provide a large boost to lower- and middle-income households and struggling small businesses. These two tax cuts would bring the total cost of the House plan to just over $1 trillion.

There are very reasonable concerns that the cost of all the actions policymakers are taking to quell the crisis will overwhelm the government's resources and exacerbate the nation's daunting long-term budget challenges. There is no doubt that the federal debt load will rise substantially as a result, from about 40% of GDP to as much as 60% of GDP, as the budget deficit this year and next will collectively total several trillion dollars. It is important to consider, however, that the nation's budgetary problems will likely become even worse if policymakers do not respond aggressively to the crisis, because the sliding economy would undermine tax revenues and result in much higher government outlays. Moreover, although running massive deficits is highly undesirable, the resulting debt load is still manageable. Global investors are fully expecting this and remain avid buyers of Treasury debt, in part because there is little private sector borrowing at this time and in part because the U.S. remains the global economy's Aaa credit. Reflecting this, Treasury yields remain near record lows. For the U.S. to maintain its financial standing, however, policymakers must immediately begin to address the nation's long-term fiscal challenges.

Any fiscal stimulus plan has to be about more than dollars and cents to be effective in lifting spirits and the economy, however. It must be passed quickly and explained well so that households and businesses are convinced it will work. Unless the plan helps dissipate the dark mood, it will not stem the economic downturn.

INTRODUCTION

The global financial system has effectively collapsed, undermining investor, household and business confidence and pushing the economy into a lengthy and severe recession. Real GDP, employment, industrial production and retail sales are falling sharply, and unemployment is rising quickly. Policymakers are working to implement a large fiscal stimulus package; yet, even with such a stimulus, the economy appears headed toward its worst downturn since the Great Depression.

The proximate cause of the crisis was the collapse of the U.S. housing market and the resulting surge in mortgage loan defaults. Hundreds of billions of dollars in losses on these mortgages have undermined the financial institutions that originated and invested in them, including some of the world's largest. Many have failed, and others are struggling to survive. Banks fear extending credit to one another, let alone to businesses and households. With the credit spigot closing, the global economy is withering. Global stock investors have dumped holdings as they come to terms with the implications for corporate earnings. A self-reinforcing adverse cycle has begun: The eroding financial system is upending the economy, putting further pressure back on the financial system as the performance of assets from credit cards to commercial mortgage loans sours.

This cycle can be broken only by aggressive and consistent government action. In the United States, the public policy response to the financial crisis has been without precedent. The full faith and credit of the U.S. government now effectively backstops the financial system, significant parts of which have been nationalized. With the takeover of Fannie Mae and Freddie Mac, the government makes nearly all the nation's residential mortgage loans. And as the $700 billion Troubled Asset Relief Program is deployed, the government is gaining sizable ownership stakes in the nation's largest financial institutions.

In an effort to restart money and credit markets, the Federal Reserve has vastly expanded its role. The Fed has adopted a zero interest rate policy, and in an attempt to bring down long-term interest rates, it has made clear that the funds rate will remain there indefinitely. The Fed is also ramping up a policy of quantitative easing, in which it effectively prints money to purchase securities and extend loans to financial institutions that use their securities as collateral.[ii] The central bank is already purchasing commercial paper and debt issued by Fannie Mae and Freddie Mac and the mortgage securities they insure. If conditions continue to erode, the Fed will turn to buying long-term Treasury bonds and perhaps eventually municipal bonds, corporate bonds, and even corporate equity.

Money markets have responded to the Fed's unprecedented actions. Libor has fallen, suggesting that the interbank lending market is performing better. Commercial paper rates have fallen, and the volume of new issuance has increased sharply. Residential mortgage rates have also declined, with 30-year fixed rates for prime conforming borrowers falling from above 6% to nearly 5%. Despite the improvement, money-market conditions remain far from normal, and even after financial institutions begin lending more freely to one another, they will be slow to extend credit to households and businesses, considering their worries about creditworthiness in a severe recession. Moreover, lower mortgage rates will not quickly revive home sales, given rising unemployment and plunging house prices. The link between the Federal Reserve's actions and the economy runs through the financial system. With that system in disarray, the efficacy of monetary policy has been significantly impaired.

Policymakers have also worked directly to shore up the housing and mortgage markets and the broader economy. A number of programs have been put in place to enable stressed homeowners to avoid foreclosure. These include FHA Secure, Hope Now, and Hope for Homeowners. Fiscal stimulus measures, including last summer's refundable tax rebates and investment tax incentives, have provided some economic support.

Much more needs to be done to quell the financial panic and mitigate the severe downturn. The remaining $350 billion in TARP funds must be deployed aggressively and broadly. Most of the initial $350 billion in TARP funds was used to inject equity into the financial system; although this helped forestall a complete collapse, it did not significantly improve the flow of credit to households and businesses. To do this, some of the remaining TARP money must be used to either purchase troubled assets from distressed institutions or provide guarantees against losses on those assets, or both. These steps would help establish a market and prices for these assets. Only then will private investors be able to determine the value of financial institutions, a prerequisite for providing them with private capital.

The remaining TARP money should also be used to fund a much larger and more comprehensive foreclosure mitigation plan. Millions of homeowners owe more than their homes are worth, and unemployment is rising quickly. Foreclosures, already at record high levels, are sure to mount. The Hope Now and Hope for Homeowners programs face severe impediments, and even under the best of circumstances will likely be overwhelmed by the wave of foreclosures still coming. No plan will keep house prices from falling further, but quick action could avoid the darker scenarios in which crashing house prices force millions more people from their homes, completely undermining the financial system and economy.[iii]

The top priority should be the implementation of a large fiscal stimulus package. The House Democratic plan proposed in mid-January includes both increases in government spending and tax cuts. The plan would cost approximately $825 billion, equal to 5.5% of the nation's gross domestic product. This is not as costly as the public works projects of the 1930s, but it is costlier than the 3% of GDP spent to stimulate the economy during the tough downturn in the early 1980s. The cost of the current package would thus be consistent with expectations regarding the severity of this downturn. At 5.5% of GDP, the stimulus would also be about enough to ensure that the economy stops contracting by the end of 2009 and that GDP returns to its prerecession peak by the end of 2010—reasonable goals.

The mix of tax cuts and spending increases in the stimulus package is designed to provide both quick relief and a substantial boost to the struggling economy. The tax cuts will not pack a big economic punch, as some of the money will be saved and some used to repay debt, but they can be implemented quickly. Aid to state and local governments will not lift the economy, but it will forestall cuts in programs and payrolls that many governments would be forced to make to meet their states' constitutional obligations to balance their budgets. Infrastructure spending will not help the economy quickly, as it will take time to get even "shovel-ready" projects going, but it will provide a significant economic boost. Because the economy's problems are not expected to abate soon, this spending will be especially helpful this time next year.

With government making so many monumental decisions in such a short time, there will surely be unintended consequences. Some may already be evident: Nationalizing Fannie Mae and Freddie Mac while not rescuing Lehman Brothers from bankruptcy may very well have set off the financial panic. The former Treasury secretary's reversal on the use of TARP to purchase troubled assets began a chain of events that resulted in the near failure of Citigroup. And policymakers need to be wary of the costs of their actions, as global investors will eventually demand higher interest rates on the soaring volume of U.S. Treasury debt. Any measurable increase in long-term interest rates would be counterproductive; its effect on the housing market and the rest of the economy would offset the economic benefits of the fiscal stimulus.

But policymakers' most serious missteps so far have come from acting too slowly, too timidly, and in a seemingly scattershot way. Early in the crisis, there were reasonable worries about moral hazard and fairness: Bailing out those who took on, originated or invested in untenable mortgage loans would only encourage such bad behavior in the future. And a bailout would certainly be unfair to homeowners still managing to make their mortgage payments. But as the crisis deepened and continued, those worries hindered policymakers far too long, allowing the panic to develop.

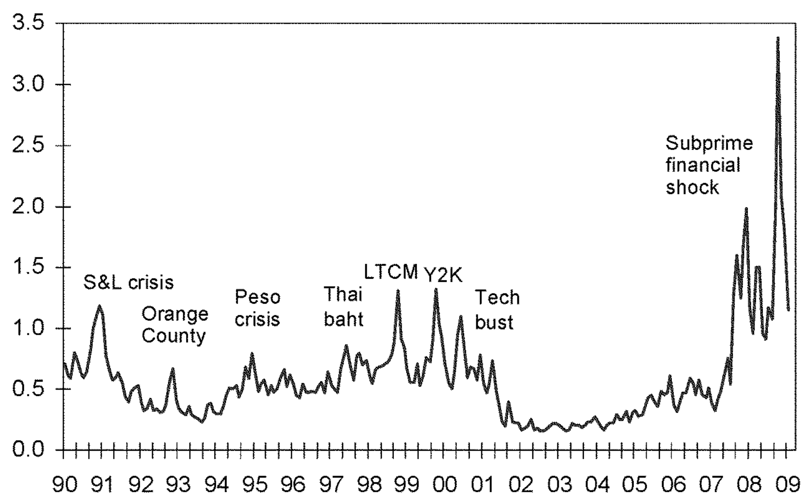
With so many people suffering so much financial loss, moral hazard is less of an issue. Debate about whether it is fair to help distressed homeowners stay in their homes appears quaint. Their problems are clearly everyone's problems. Only concerted, comprehensive and consistent government action will instill the confidence necessary to restore financial stability and restart economic growth.

ECONOMIC BACKDROP

The need for more policy action grows more evident as the financial and economic backdrop darkens. The financial panic that began in early September with the nationalization of Fannie and Freddie may have passed its apex, but the collective psyche remains frazzled. And even if the panic soon subsides, substantial economic damage has been done. The collapse in confidence, the massive loss of wealth, and the intensifying credit crunch ensure the U.S. economy will struggle for some time.

Money markets are improving thanks to massive intervention by global central banks but remain far from normal. The difference between three-month Libor and three-month Treasury bill rates—a good proxy for the angst in the banking system—is still an extraordinarily wide 100 basis points (see Chart 1).[iv] This spread is down from the record spreads of mid-October, which topped 450 basis points, but it is still very high compared with past financial crises, not to mention the average 50-basis point spread that prevails in normal times. The Fed's program to purchase commercial paper directly from issuers has pushed those short-term rates down as well, but they too are still very high.

Chart 1: The Financial System on the Precipice of Collapse
Difference between 3-month Libor and Treasury bill yields



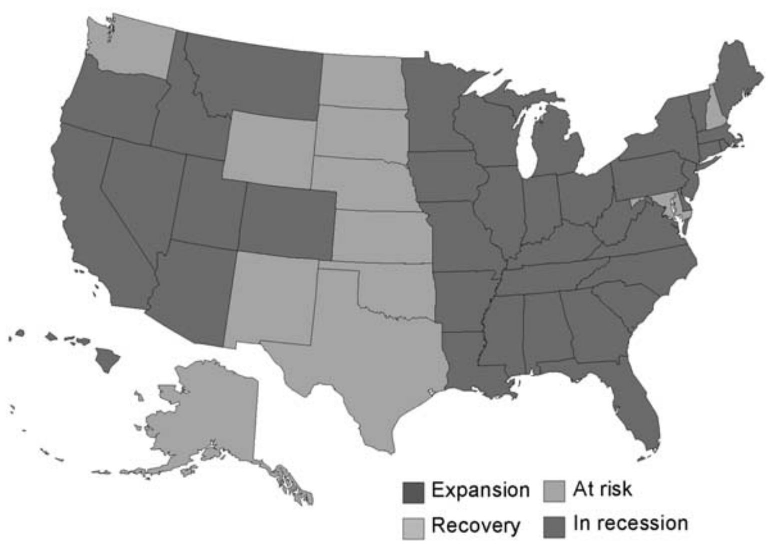
Credit markets remain badly shaken. Bond issuance has come to a standstill. No residential or commercial mortgage-backed securities have been issued in recent months, and there has been little issuance of junk corporate bonds and emerging market debt. Asset-backed issuance of credit cards and vehicle and student loans and issuance of municipal bonds also remain severely disrupted. Investment-grade bond issuance has held up somewhat better, but that too all but dried up in October and early November. Credit spreads—the extra yield investors require to be compensated for investing in riskier bonds—also remain strikingly wide as investors shun anything but risk-free Treasury bonds. The difference between yields on junk corporate bonds and 10-year Treasuries had ballooned to over 2,000 basis points, and the difference between emerging debt and Treasuries to over 1,200 basis points. Historically, yield spreads for both have averaged closer to 500 basis points.

Commodity and foreign currency markets have been roiled. Oil prices have fallen more than 50% from their record peaks in early July, and prices for commodities from copper to corn have plunged. The global recession has undercut the financial demand that had sent prices surging this past summer. Economies reliant on commodity production have been hit hard, and their currencies have rapidly depreciated. The Canadian dollar, which had been close to parity with the U.S. dollar as recently as this summer, has dropped back to less than 80 U.S. cents, and the Brazilian real has fallen more than 40% against the U.S. dollar since the panic began.[v]

Volatility in global stock markets has been unprecedented and the price declines nerve-wracking. Since the downdraft began a few months ago, global stock prices are off 30% in local currency terms and more than 40% from their year-ago highs. No market has been spared. The declines have been so precipitous that U.S. and European bourses have tried imposing limits on short-selling, and Russia has suspended trading for days at a time, but without meaningful effect. Mutual fund, 401(k) and hedge fund investors simply want out of stocks, regardless of the losses and any associated penalties.

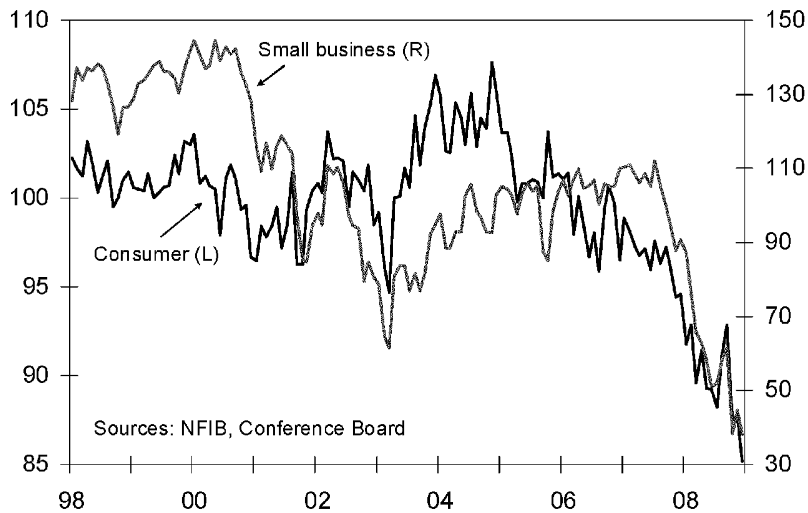
Even if the global financial system stabilizes soon, substantial damage has already been done. The U.S. economy was struggling before the financial panic hit; it has been in recession for over a year. Real GDP fell in the last quarter of 2007 and again in the third quarter of 2008.[vi] Some 2.6 million jobs have already been lost so far on net, and the unemployment rate has risen nearly 3 percentage points to 7.2%. The downturn is broad-based across industries and regions, with 38 states now in recession (see Chart 2).[vii] Data since the panic hit have been uniformly bad, suggesting the downturn is intensifying. Retail sales, vehicle sales and industrial production have plunged, and the increase in unemployment insurance claims in January is consistent with another monthly job loss of 500,000.

Chart 2: Recession From Coast to Coast



The panic's most immediate fallout is the blow to confidence. Consumer confidence crashed in October to its lowest reading since the Conference Board began its survey more than 40 years ago. This is all the more surprising given the plunge in gasoline prices during the month; cheaper motor fuel in times past has always lifted households' spirits. Small business confidence as measured by the National Federation of Independent Businesses has also plunged to a record low (see Chart 3). Current events have so soured sentiment that they are sure to have long-lasting effects on household spending and saving, as well as on business decisions regarding payrolls and investment.

Chart 3: Confidence Has Been Shattered
Indices



IS THE HOUSE STIMULUS PLAN THE APPROPRIATE SIZE?

The $825 billion, two-year fiscal stimulus plan proposed by House Democrats is large enough to provide a substantive near-term boost to the economy, but not so large as to result in measurably higher interest rates. Global investors remain avid buyers of U.S. Treasury bonds despite fully anticipating the costs to the Treasury of responding to the financial and economic crisis. Investors have discounted a stimulus plan whose costs are similar to those proposed by the House. This is not say the U.S. government can borrow unlimited amounts without pushing interest rates higher, but with little corporate and household borrowing, the government is able to borrow at very low interest rates.

The costs of the House plan are approximately equal to the estimated direct net cost to the economy of the financial panic. The hit to household wealth is among the most significant costs. Net worth has fallen close to $12 trillion since peaking a year ago. Of that, $4 trillion is due to the 25% decline in house prices, while the rest is due to the 40% decline in stock prices (see Chart 4). Every dollar decline in household net worth reduces consumer spending by 5 cents over the next two years.[viii] If sustained, the wealth lost over the past year could thus cut $300 billion from consumer spending in 2009 and a like amount in 2010. More than in past recessions, the financial pain of this recession is being felt by all Americans, from lower-income households losing jobs to affluent households with diminished nest eggs.

The financial panic has also significantly impaired the availability of credit and increased its cost. Credit growth was weakening rapidly even before recent events. The Federal Reserve's Flow of Funds shows that debt owed by households and nonfinancial corporations actually fell in the second and third quarters of 2008 after inflation for the first time since the savings and loan crisis of the early 1990s. To date, weakening credit growth is largely due to disruptions in the bond and money markets. Lending by banks, S&Ls and credit unions has remained sturdy. But this is probably because nervous borrowers have pulled down available credit lines, and with banks now tightening underwriting standards and cutting lines, this source of credit is drying up. According to the Fed's senior loan officer survey, lenders have tightened credit over the past year as aggressively as ever. The net percent of loan officers who say they are willing to make a consumer loan is the lowest on record, with the exception of 1980, when the Carter administration briefly imposed credit controls (see Chart 5).[ix]

Chart 4: Household Nest Eggs Have Been Cracked
Household net worth, $ tril

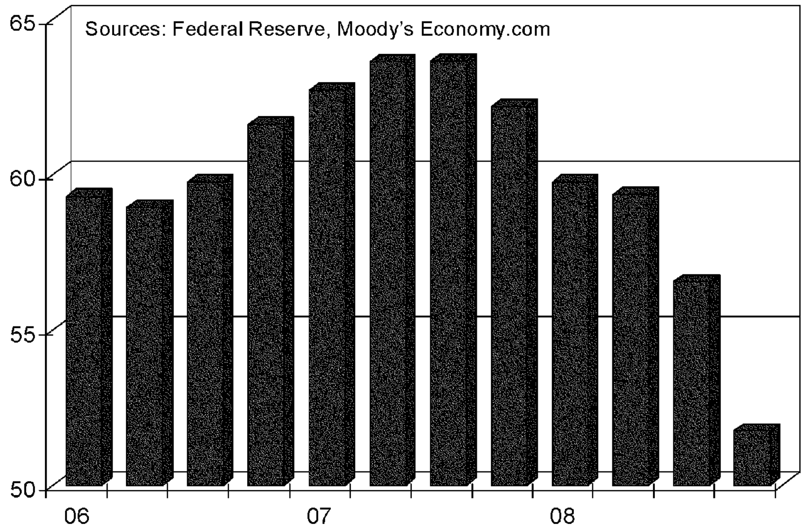
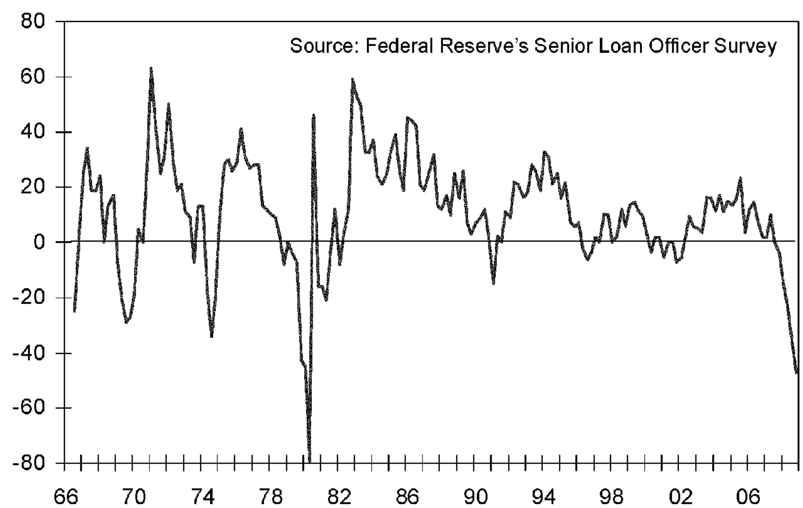


Chart 5: Banks Fight to Survive, Not to Make Loans
Net % of lenders willing to make consumer loans



The impact of a credit crunch is difficult to quantify, but the economy's performance during the early 1980s and early 1990s suggests it can be substantial. The downturn in the 1980s was the most severe in the post-World War II period, and although the downturn in the 1990s was not as bad, the economy struggled long after the recession formally ended. Using these two periods as a guide suggests that for every 1 percentage point decline in real household and nonfinancial corporate debt outstanding, real GDP declines by approximately 35 basis points. Thus, if real debt outstanding declines 12.5% from its early 2008 peak to a trough in late 2010, which seems plausible, this credit effect will cut approximately $325 billion from GDP this year and a similar amount next year.

The only significant positive for the U.S. economy out of the financial panic is lower energy and commodity prices. With oil now trading at nearly $50 per barrel, a gallon of regular unleaded gasoline should cost about $1.75. Gasoline prices peaked last summer above $4 per gallon and have averaged closer to $3 last year. Every penny per gallon decline in the cost of gasoline saves U.S. consumers just over $1 billion a year. Assuming gas remains below $2 per gallon through the coming year, Americans will save well more than $100 billion in 2009 compared with fuel costs in 2008. There will also be measurable savings on home heating and food bills as agricultural and transportation costs fall. Total savings in 2009 compared with 2008 will thus approach $200 billion.

Calculating the costs to the economy from the wealth and credit effects, less the benefits from lower commodity prices, puts the net direct cost of the financial panic this year at $425 billion in 2009 and a like amount in 2010 (a $300 billion wealth effect plus a $325 billion credit crunch effect minus $200 billion in savings due to lower commodity prices). That is about the cost of the House stimulus plan. This is a simplistic analysis; it does not account for all the indirect costs of the panic to the economy and the multipliers, but it gives a sense of the fallout's magnitude.

WHAT IS IN THE HOUSE STIMULUS PLAN?

The plan includes a reasonably designed mix of about $550 billion in government spending increases and $275 billion in tax cuts. Although the timing of the stimulus has yet to be determined, the tax cuts are expected to occur largely in 2009-2010, and much of the spending would begin in 2010 (see Table 1). A recent Congressional Budget Office analysis raised the significant concern that if experience is a reliable guide, then much of the spending may not occur until well after 2010. The economic benefit will be measurably diluted if indeed past is prologue. Policymakers will need to choose projects that can be implemented quickly and establish mechanisms to provide the oversight necessary to ensure that these projects are done in a timely fashion. For the purposes of this analysis, it is assumed that approximately 80% of the stimulus in the package will be provided to the economy by the end of 2010.[x]

Table 1: $825 Billion House Democratic Economic Stimulus Plan

Sources: BLS, BEA, Moody's Economy.com

Calendar years	2009	2010	2011	2012	2009-12
Total Stimulus	224	436	121	44	825
Government Spending	145	306	88	11	550
Income Support	44	58	0	0	102
Unemployment Insurance Benefits	18	25	0	0	43
Food Stamps	9	11	0	0	20
COBRA Healthcare	17	22	0	0	39
Infrastructure Spending	9	77	62	11	158
Traditional Infrastructure	5	46	35	4	89
Non-Traditional Infrastructure	4	32	27	7	70
Aid to State Government	66	118	27	0	211
Medicaid Match	31	52	4	0	87
Fiscal Relief	23	40	16	0	79
Local School Districts	11	24	6	0	41
Law Enforcement	1	2	1	0	4
Healthcare/Education/Other	26	53	0	0	79
Tax Cuts	79	130	33	33	275
Business Tax Benefits	45	65	-40	-45	25
Inividual Tax Benefits	34	65	73	78	250

Increased government spending provides a large economic bang for the buck and thus significantly boosts the economy. The benefits begin as soon as the money is disbursed and are less likely than tax cuts to be diluted by an increase in imports. The most effective proposals included in the House stimulus plan are extending unemployment insurance benefits, expanding the food stamp program, and increasing aid to state and local governments. Increasing infrastructure spending will also greatly boost the economy, particularly because the downturn is expected to last for an extended period. Most of the infrastructure money will be spent to hire workers and buy materials and equipment produced domestically.

Tax cuts generally provide less of an economic boost, particularly if they are temporary; on the other hand, they can be implemented quickly. A particular advantage of the individual tax cuts in the House stimulus plan such as the payroll tax and earned income tax credits is that they are targeted to benefit lower- and middle-income households, which are more likely to spend the extra cash quickly. Investment and job tax benefits for businesses are less economically effective but are not very costly, and they more widely distribute the benefits of the stimulus.

INCOME SUPPORT

The plan includes some $100 billion in income support for those households under significant financial pressure. This includes extra benefits for workers who exhaust their regular 26 weeks of unemployment insurance benefits; expanded food stamp payments; and help meeting COBRA payments for unemployed workers trying to hold onto their health insurance.

Increased income support has been part of the federal response to most recessions, and for good reason: It is the most efficient way to prime the economy's pump. Simulations of the Moody's Economy.com macroeconomic model show that every dollar spent on UI benefits generates an estimated $1.63 in near-term GDP.[xi] Boosting food stamp payments by $1 increases GDP by $1.73 (see Table 2). People who receive these benefits are hard-pressed and will spend any financial aid they receive very quickly.

Table 2: Fiscal Stimulus Bang for the Buck	
Source: Moody's Economy.com	
	Bang for the Buck
Tax Cuts	
Non-refundable Lump-Sum Tax Rebate	1.01
Refundable Lump-Sum Tax Rebate	1.22
Temporary Tax Cuts	
Payroll Tax Holiday	1.28
Across the Board Tax Cut	1.03
Accelerated Depreciation	0.25
Loss Carryback	0.19
Permanent Tax Cuts	
Extend Alternative Minimum Tax Patch	0.49
Make Bush Income Tax Cuts Permanent	0.31
Make Dividend and Capital Gains Tax Cuts Permanent	0.38
Cut in Corporate Tax Rate	0.30
Spending Increases	
Extending Unemployment Insurance Benefits	1.63
Temporary Increase in Food Stamps	1.73
General Aid to State Governments	1.38
Increased Infrastructure Spending	1.59
Note: The bang for the buck is estimated by the one year $ change in GDP for a given $ reduction in federal tax revenue or increase in spending	

Another advantage is that these programs are already operating and can quickly deliver a benefit increase to recipients. The virtue of extending UI benefits goes beyond simply providing aid for the jobless to more broadly shoring up household confidence. Nothing is more psychologically debilitating, even to those still employed, than watching unemployed friends and relatives lose their sources of support.[xii] Increasing food stamp benefits has the added virtue of helping people ineligible for UI such as part-time workers.

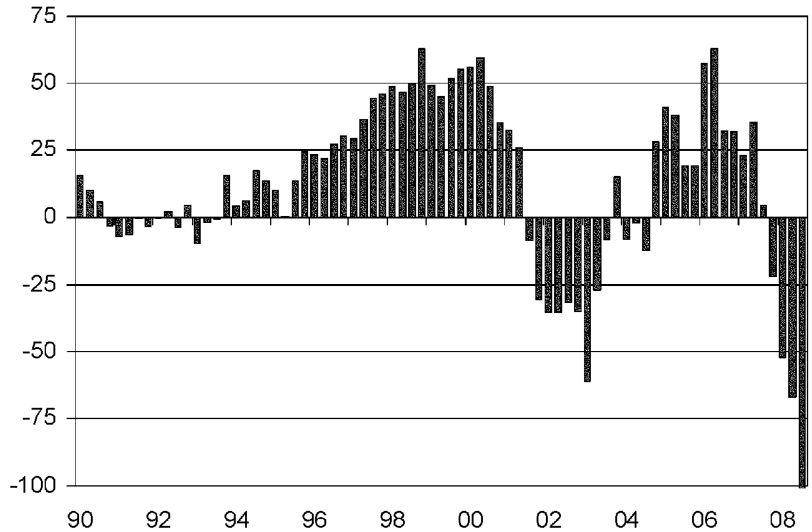
AID TO STATE AND LOCAL GOVERNMENTS

Another potent tool in the plan is some $200 billion in aid to state and local governments in the form of a temporary increase in the Medicaid matching rate to ease the costs of healthcare coverage; help for school districts; and broader fiscal relief to states to prevent cuts in key programs.

More than 40 states and a rapidly increasing number of localities are grappling with significant fiscal problems. Tax revenue growth has slowed as home sales, property values, retail sales and corporate profits have all fallen. Personal income tax receipts have begun to suffer as the job market slumps. Big states including California and Florida are under severe financial pressure, and smaller states including Arizona, Minnesota and Maryland are struggling significantly. The gap between state and local government revenues and expenditures ballooned to over $100 billion—a record—in the third quarter of 2008, according to the Bureau of Economic Analysis (see Chart 6).

Chart 6: State & Local Budget Shortfalls Worsen

State and local govt. expenditures less tax revenues, $ bil



Because most state constitutions require their governments to eliminate deficits quickly, most have drawn down their reserve funds and have already begun to cut programs from healthcare to education. Cuts in state and local government outlays are sure to be a substantial drag on the economy in 2009 and 2010. Additional federal aid to state governments will fund existing payrolls and programs, providing a relatively quick boost. States that receive checks from the federal government will quickly pass the money to workers, vendors and program beneficiaries.

Arguments that state governments should be forced to cut spending because they have grown bloated and irresponsible are strained, at best. State government spending and employment are no larger today as a share of total economic activity and employment than they were three decades ago. The contention that helping states today will encourage more profligacy in the future also appears overdone. Apportioning federal aid to states based on their size, rather than on the size of their budget shortfalls, would substantially mitigate this concern.

INFRASTRUCTURE SPENDING

The increased infrastructure spending in the House plan is also a particularly effective way to stimulate the economy. The plan includes $160 billion in such spending, with $90 billion in more traditional infrastructure projects such as highway construction, public transit and waterways; and $70 billion for a variety of energy, science and healthcare projects. The boost to GDP from every dollar spent on public infrastructure is large—an estimated $1.59—and there is little doubt that the nation has underinvested in infrastructure for some time, to the increasing detriment of the nation's long-term growth prospects.

The argument against including infrastructure spending as a part of any fiscal stimulus plan is that it takes substantial time for the funds to flow into the broader economy.[xiii] Infrastructure projects can take years from planning to completion. Moreover, even if the funds are used to finance only projects that are well along in their planning—so-called shovel-ready projects—it is difficult to know just when projects will get under way and when the money will be spent. These are reasonable concerns in most recessions, but the economy's current problems appear likely to continue for some time. It is also reasonable to be worried that this money will be spent on pork-barrel projects chosen for political rather than economic reasons. To address this worry, policymakers plan to put in place tight controls to monitor the spending.[xiv]

TAX CUTS

The House stimulus plan includes an estimated $165 billion in tax cuts for individuals and $110 billion in business tax cuts. The largest part of the individual tax cut is a permanent payroll tax credit for workers, amounting to as much as $1,000 for married couples. The earned income tax credit will also be expanded. Business tax provisions include bonus depreciation allowances and a five-year carry-back of net operating losses, which allows firms to convert losses into cash by claiming a refund of taxes paid in previous years.

The payroll tax credit will be particularly effective, as the benefit will go to lower-income households that do not necessarily earn enough to pay income tax. These households are much more likely to spend any tax benefit they receive. There has also been concern that the tax benefit will do little to stimulate spending, that most of it will be saved or used to meet debt payments. Fueling this concern is the apparently small lift to consumer spending that occurred last spring and early summer, when households received more than $100 billion in tax rebates as part of last year's stimulus plan. The consumer spending impact of that earlier tax stimulus was larger than generally believed, however, as higher-income households that did not receive that rebate significantly curtailed their spending at the same time that lower-income households spent their rebates.[xv] Total consumer spending rose only modestly as a result. Households would also be more likely to spend the payroll tax benefit in the House stimulus plan, since it is a permanent reduction in their tax liability.

The temporary tax incentives to support business investment and hiring in the House stimulus plan do not provide a particularly large economic benefit. Accelerated depreciation by large businesses and expensing of investment by small businesses lowers the cost of capital only modestly and is not a critical factor in businesses' investment decisions, particularly when sales and pricing are so weak. The carry-back of business losses helps cash-strapped businesses, perhaps forestalling some cuts in investment and jobs, but it is unlikely to prompt much additional business expansion, as it does not improve businesses' prospects. However, including business tax cuts in the stimulus plan is not very expensive, and they do distribute the benefits of the stimulus more widely. This will be useful if it expands political support for the stimulus plan and thus accelerates its adoption. Moreover, the depreciation benefits included in last year's fiscal stimulus have expired, and extending them through 2010 would forestall a badly timed additional factor, however small,depressing business investment.

THE NATIONAL ECONOMIC IMPACT

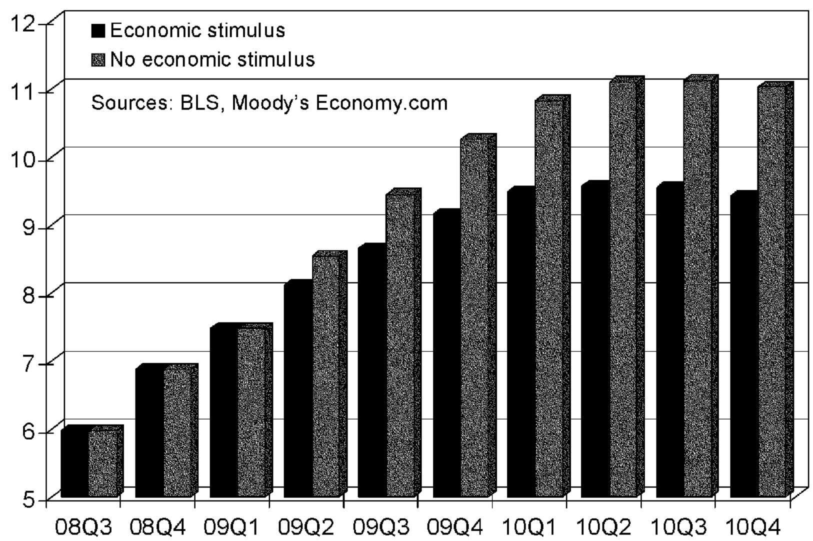
Implementing the House Democratic fiscal stimulus plan in early 2009 would substantially benefit the economy. The stimulus will not keep the downturn from becoming the worst since the Great Depression, but it will ensure that it remains a recession and not a depression.[xvi]

This assessment is based on simulations of the Moody's Economy.com macroeconomic model system. Assuming no added fiscal stimulus except for that provided by the automatic stabilizers already in place, real GDP would decline for eight straight quarters, falling by a stunning 4.2 % in 2009 and another 2.2% in 2010. This would be more severe than the early 1980s recessions, which, combined, were the worst since the Depression. Some 8 million jobs would be lost from the peak in employment at the start of 2008 to the bottom in employment by late 2010, pushing the unemployment rate to well over 11% by early 2011.

The House plan would not forestall a sizable decline of 2.5% in real GDP in 2009, but it would ensure that real GDP returns to its previous peak by early 2011 (see Table 3). The stimulus limits the peak-to-trough decline in jobs to some 5.5 million, and the unemployment rate peaks at nearly 9.5% in summer 2010. With the stimulus, the unemployment rate falls back to its full employment rate of close to 5% by early 2013. Without the stimulus, the unemployment rate rises to well over 11% and ends 2012 at a still-extraordinary high of nearly 8% (see Chart 7).

Table 3: The Economic Benefit of $825 Billion House Democratic Stimulus Plan						
Sources: BEA, BLS, Moody's Economy.com						
	Real GDP, Billions 2000$			**Real GDP, % Change**		
	No Stimulus	Stimulus	Difference	No Stimulus	Stimulus	Difference
2007	11,523.9	11,523.9	-	2.03	2.03	-
2008	11,662.0	11,662.0	-	1.20	1.20	-
2009	11,265.5	11,372.6	107.0	-3.40	-2.48	0.9
2010	11,108.2	11,471.7	363.5	-1.40	0.87	2.3
2011	11,356.6	11,979.4	622.8	2.24	4.43	2.2
2012	11,887.5	12,642.5	755.0	4.67	5.54	0.9
	Unemployment Rate			**Payroll Employment, Millions**		
	No Stimulus	Stimulus	Difference	No Stimulus	Stimulus	Difference
2007	4.64	4.64	-	137.6	137.6	-
2008	5.78	5.78	-	137.2	137.2	-
2009	9.02	8.35	(0.7)	132.9	133.7	0.8
2010	11.09	9.51	(1.6)	130.8	133.2	2.4
2011	10.53	8.31	(2.2)	132.0	136.3	4.3
2012	8.91	6.26	(2.7)	135.8	140.7	4.9

Chart 7: Fiscal Stimulus Makes a Significant Difference
Unemployment rate



Despite the added federal government borrowing necessary to finance the stimulus, it will not lead to excessively higher long-term interest rates. Considering the current demands on the Treasury, total bond issuance with the stimulus will rise to a record of more than $2 trillion in fiscal 2009 and about the same in fiscal 2010, but private bond issuance will remain extraordinarily depressed during this period. Now moribund, the flow of corporate, emerging market, and private-label mortgage and asset-backed debt will eventually revive. However, total credit market needs including the Treasury's issuance will remain modest, so that the 10-year Treasury yield would remain below 4% through 2010. It is now nearly 2.5%. Other long-term rates, including corporate bond and mortgage rates, would rise even less as credit spreads narrowed, reflecting the stronger economy and reduced credit concerns.

INDUSTRY AND REGIONAL ECONOMIC EFFECTS

All major industries stand to benefit from the House Democratic stimulus plan. There are 3 million more jobs with the stimulus than without it by the fourth quarter of 2010, equal to 2.3% of the job base. The largest boost to employment from the stimulus is in the construction trades, with employment in the industry 6.6% higher with the stimulus by the end of 2010 than without it (see Table 4). Manufacturing employment is also significantly lifted by almost 2.4%. Construction and manufacturing benefit substantially from the plan's infrastructure spending.

Table 4: Industry Employment Impact of $825 Billion House Stimulus Plan

Difference in Payroll Employment in Stimulus vs. No Stimulus Scenarios

Sources: BLS, Moody's Economy.com

	2010Q4		2012Q4	
	Thousands	%	Thousands	%
Total Nonagricultural	3,029	2.3	4,658	3.4
Natural Resources and Mining	26.1	3.5	7.8	1.0
Construction	398.3	6.6	706.5	10.6
Manufacturing - Total	287.7	2.4	533.6	4.3
Wholesale Trade	141.1	2.5	173.5	2.9
Retail Trade	385.7	2.7	639.7	4.4
Information	70.6	2.5	34.5	1.2
Financial Activities	216.2	2.8	288.5	3.6
Professional and Business Services	374.6	2.2	812.2	4.5
Education and Health Services	215.2	1.1	267.6	1.3
Leisure and Hospitality	346.2	2.7	584.3	4.3
Other Services	147.0	2.7	135.1	2.4
Government - Total	307.5	1.4	351.2	1.6
Utilities	9.8	1.8	3.8	0.7
Transportation and Warehousing	102.8	2.4	119.5	2.7

Employment in the retail and leisure and hospitality industries, including restaurants, is lifted by the stimulus. This comes in part directly from the individual tax cuts but more importantly from the indirect impact of increased employment and income that the stimulus provides in the rest of the economy. It is also important to note that part-time employment is much higher in retailing than in other industries, increasing the measured employment impact of the stimulus on retailing.

State and local government and education and health services benefit significantly from the stimulus plan, but the lift to employment is not as pronounced as in other industries. Employment in these areas is approximately 1.4% higher with the stimulus than without it, about half the percentage boost to employment experienced in the broader economy. Some of the aid to state and local governments in the stimulus will fund activities—and thus jobs—in the private sector.

All regions of the country will benefit from the fiscal stimulus, but some will benefit more than others. The most significant boost is provided to states now hit hardest by the housing and foreclosure crises such as Florida and Nevada, those that rely heavily on the financial services industry such as New York and New Jersey, and those that depend on the auto industry such as Michigan and Ohio (see Tables 5 and 6). Without a fiscal stimulus, the job market would suffer significantly, inducing more foreclosures in those parts of the country where house prices have fallen most sharply and undermining demand for big-ticket items such as vehicles and discretionary activities such as travel and tourism. Layoffs on Wall Street will also intensify as financial markets and institutions are hammered.

Table 5: State Employment Impact of $825 Billion House Stimulus Plan

Difference in Payroll Employment in Stimulus vs. No Stimulus Scenarios

Sources: BLS, Moody's Economy.com

	2010Q4		2012Q4	
	Thousands	%	Thousands	%
United States	3,029	2.31	4,657.79	3.39
Alaska	3.79	1.21	7.47	2.26
Alabama	37.09	1.88	58.39	2.80
Arkansas	20.33	1.73	30.04	2.44
Arizona	125.47	5.13	125.64	4.77
California	815.99	5.82	870.05	5.88
Colorado	70.47	3.05	98.01	4.00
Connecticut	45.96	2.87	65.50	3.93
District Of Columbia	27.19	3.92	23.54	3.27
Delaware	11.95	2.89	16.91	3.86
Florida	329.55	4.46	512.69	6.51
Georgia	143.11	3.61	188.38	4.44
Hawaii	19.19	3.27	21.90	3.53
Iowa	34.28	2.38	34.17	2.28
Idaho	15.40	2.43	22.31	3.32
Illinois	203.60	3.60	271.14	4.60
Indiana	109.43	3.86	149.33	5.05
Kansas	19.18	1.44	29.27	2.10
Kentucky	43.87	2.48	62.73	3.36
Louisiana	32.18	1.72	57.91	2.92
Massachusetts	94.56	3.06	119.84	3.71
Maryland	99.20	3.92	91.77	3.44
Maine	14.65	2.50	21.64	3.54
Michigan	158.19	4.14	235.79	6.00
Minnesota	91.90	3.47	128.14	4.59
Missouri	71.03	2.67	105.80	3.82
Mississippi	14.63	1.33	26.21	2.29
Montana	9.43	2.18	9.10	2.03
North Carolina	132.35	3.31	156.19	3.68
North Dakota	5.66	1.59	5.37	1.45
Nebraska	19.22	2.01	30.12	3.00
New Hampshire	22.83	3.62	28.35	4.25
New Jersey	171.39	4.51	213.52	5.40
New Mexico	16.38	1.96	29.41	3.28
Nevada	62.58	5.09	65.04	4.86
New York	390.77	4.79	523.23	6.20
Ohio	171.75	3.38	253.54	4.81
Oklahoma	26.94	1.75	32.27	1.99
Oregon	52.89	3.16	61.21	3.46
Pennsylvania	188.74	3.43	216.12	3.78
Rhode Island	15.20	3.37	21.95	4.64
South Carolina	37.20	1.96	55.41	2.77
South Dakota	7.18	1.77	8.43	1.99
Tennessee	63.69	2.39	93.41	3.35
Texas	301.45	2.87	349.13	3.10
Utah	22.49	1.87	28.21	2.22
Virginia	116.58	3.22	156.94	4.12
Vermont	7.17	2.46	10.18	3.37
Washington	94.29	3.25	100.28	3.25
Wisconsin	67.38	2.50	98.65	3.53
West Virginia	14.56	2.03	23.73	3.16
Wyoming	4.05	1.39	5.07	1.65

Table 6: State Unemployment Rate Impact of $825 Billion House Stimulus Plan		
Difference in Unemployment Rate in Stimulus vs. No Stimulus Scenarios		
Sources: BLS, Moody's Economy.com		
	2010Q4	**2012Q4**
	Percentge Points	Percentage Points
United States	-1.6	-2.5
Alaska	-0.8	-1.8
Alabama	-1.4	-2.1
Arkansas	-1.3	-1.9
Arizona	-1.6	-2.6
California	-1.4	-2.7
Colorado	-1.3	-2.1
Connecticut	-1.3	-2.2
District Of Columbia	-1.2	-2.4
Delaware	-1.5	-2.2
Florida	-1.6	-2.6
Georgia	-1.0	-2.1
Hawaii	-1.3	-2.0
Iowa	-1.0	-1.5
Idaho	-1.2	-1.9
Illinois	-1.1	-2.3
Indiana	-1.3	-2.3
Kansas	-1.1	-1.9
Kentucky	-0.9	-2.0
Louisiana	-1.3	-1.8
Massachusetts	-1.2	-2.3
Maryland	-1.4	-2.1
Maine	-1.3	-2.2
Michigan	-1.4	-2.9
Minnesota	-1.2	-2.1
Missouri	-1.4	-2.3
Mississippi	-0.7	-2.1
Montana	-1.1	-1.9
North Carolina	-0.9	-2.1
North Dakota	-0.9	-1.4
Nebraska	-0.9	-1.4
New Hampshire	-1.5	-2.1
New Jersey	-1.4	-2.5
New Mexico	-1.0	-2.1
Nevada	-1.3	-2.6
New York	-1.5	-2.4
Ohio	-1.5	-2.7
Oklahoma	-1.1	-1.7
Oregon	-1.0	-2.0
Pennsylvania	-1.1	-2.0
Rhode Island	-1.3	-2.6
South Carolina	-0.9	-2.0
South Dakota	-0.8	-1.4
Tennessee	-1.1	-2.1
Texas	-0.9	-1.7
Utah	-1.0	-1.6
Virginia	-1.1	-2.0
Vermont	-1.2	-2.1
Washington	-1.4	-2.4
Wisconsin	-1.2	-2.0
West Virginia	-0.5	-1.6
Wyoming	-0.7	-1.7

The benefits of a fiscal stimulus are less pronounced in the nation's agricultural and energy-producing regions. These areas are boosted by more infrastructure spending and the increased federal aid to their state governments, but agricultural and energy prices will remain low, as they are determined in global markets and not materially changed by the fiscal stimulus.

SUGGESTIONS TO IMPROVE THE HOUSE STIMULUS PLAN?

The House plan will measurably boost the flagging economy, but policymakers may want to consider expanding it with more tax cuts. The most significant stimulus from the plan will likely occur during the first half of 2010, but the downturn will be at its most intense in 2009. Tax cuts do not provide the same economic bang for the buck as increased government spending—some of the tax cuts will be saved or used to repay debt or to purchase imported goods—but they can help the economy this year.

A refundable tax credit for a home purchased in 2009, payable at the time of the purchase to help with the downpayment, would quickly stimulate home sales and reduce the mountain of unsold homes weighing on house prices and exacerbating foreclosures and the crisis in the financial system. The current House plan does provide some direct support to the housing market by removing the current repayment requirement on the $7,500 first-time home buyer credit for homes purchased after 2008 and before termination of credit on June 30, 2009. The credit could be increased and expanded to all buyers of owner-occupied homes, not just first-time homebuyers, in 2009.

A payroll tax holiday for employees and employers in the third quarter of this year would also provide a large boost to lower- and middle-income households. Households with very high incomes will have already stopped making payroll tax contributions by this time during the year and would not benefit. It would also provide much-needed support to cash-strapped small businesses and reduce the cost of their workforces and perhaps stem some layoffs.

The cost of these two tax cuts would bring the total cost of the House plan to just over $1 trillion. Since both proposed tax cuts would be temporary, however, they would not add to the nation's long-term fiscal problems.

CONCLUSIONS

A long history of public policy mistakes has contributed to the financial and economic crises. Although there will surely be more missteps, only through further aggressive and consistent government action will the U.S. avoid the first true depression since the 1930s.

In some respects, this crisis has its genesis in the long-held policy objective of promoting homeownership. Since the 1930s, federal housing policy has been geared toward increasing homeownership by heavily subsidizing home purchases. Although homeownership is a worthy goal, fostering stable and successful communities, it was carried too far, producing a bubble when millions of people became homeowners who probably should not have. These people are now losing their homes in foreclosure, undermining the viability of the financial system and precipitating the recession.

Perhaps even more important has been the lack of effective regulatory oversight. The deregulation that began during the Reagan administration fostered financial innovation and increased the flow of credit to businesses and households. But deregulatory fervor went too far during the housing boom. Mortgage lenders established corporate structures to avoid oversight, while at the Federal Reserve, the nation's most important financial regulator, there was a general distrust of regulation.

Despite all this, the panic that has roiled financial markets might have been avoided had policymakers responded more aggressively to the crisis early. Officials misjudged the severity of the situation and allowed themselves to be hung up by concerns about moral hazard and fairness. Considering the widespread loss of wealth, it is now clear that they waited much too long to act, and their response to the financial failures in early September was inconsistent and ad hoc. Nationalizing Fannie Mae and Freddie Mac but letting Lehman Brothers fail confused and scared global investors. The shocking initial failure of Congress to pass the TARP legislation caused credit markets to freeze and sent stock and commodity prices crashing.

Now, a new policy consensus has been forged out of collapse. It is widely held that policymakers must take aggressive and consistent action to quell the panic and mitigate the economic fallout. An unfettered Federal Reserve will pump an unprecedented amount of liquidity into the financial system to unlock money and credit markets. The TARP fund will be deployed more broadly to shore up the still-fragile financial system, and another much larger and more comprehensive foreclosure mitigation program is needed to forestall some of the millions of mortgage defaults that will otherwise occur. Finally, another very sizable economic stimulus plan is vitally needed. Although there will be much more discussion about the appropriate size and mix of government spending increases and tax cuts, the House Democratic plan is a very good starting point. This is important, for although such debate is necessary, it must be resolved quickly. Unless a stimulus plan is implemented beginning this spring, its effectiveness in lifting the economy will be significantly muted.

The fiscal stimulus does carry substantial costs. The federal budget deficit, which topped $450 billion in fiscal 2008, could top $1.5 trillion in fiscal 2009 and remain as high in 2010. Borrowing by the Treasury will top $2 trillion this year. There will also be substantial long-term costs to extricate the government from the financial system. Unintended consequences of all the actions taken in such a short period will be considerable. These are problems for another day, however. The financial system is in disarray, and the economy's struggles are intensifying. Policymakers are working hard to quell the panic and shore up the economy, but considering the magnitude of the crisis and the continuing risks, policymakers must be aggressive. Whether from a natural disaster, a terrorist attack, or a financial calamity, crises end only with overwhelming government action.

ENDNOTES

[i] The House Democratic stimulus plan can be found at: *http://appropriations.house.gov/pdf/RecoveryReport01-15-09.pdf*

[ii] Federal Reserve Chairman Bernanke has recently labeled the central bank's policy, which some would describe as quantitative easing, as "credit easing." For a more complete description of how the Fed is responding to the crisis, see "The Crisis and the Policy Response," a speech at the London School of Economics, January 13, 2009. *http://www.federalreserve.gov/newsevents/speech/bernanke20090113a.htm*

[iii] A foreclosure mitigation plan that includes mortgage write-downs that I have proposed is the Homeownership Vesting Plan. See "Homeownership Vesting Plan," Regional Financial Review, December 2008.

[iv] The London interbank offered rate is the interest rate at which major banks lend to one another.

[v] Currency swings have been wild enough to prompt discussion of coordinated government intervention. This seems unlikely, in part because the currency moves until recently have been largely welcome. A stronger U.S. dollar means global investors still view the U.S. as a haven, which is important as the Treasury ramps up borrowing. Nations whose currencies are falling against the dollar are hopeful that this will reduce pressures on their key export industries.

[vi] When all the GDP revisions are in, they are expected to show that real GDP also fell in the first quarter of 2008. Second quarter growth was supported by the tax rebate checks as part of the first fiscal stimulus package.

[vii] State recessions are determined using a methodology similar to that used by the business cycle dating committee of the National Bureau of Economic Research for national recessions.

[viii] For a more thorough discussion of the wealth effect, see "MEW Matters," Zandi and Pozsar, Regional Financial Review, April 2006. In this article, the housing wealth effect is estimated to be closer to 7 cents while the stock wealth effect is nearer to 4 cents.

[ix] This was part of a failed effort to rein in the double-digit inflation of the period.

[x] This spend-out rate would be consistent with the Administration's commitment of a 75% spend-out rate by the end of fiscal year 2010 as stated in a January 22, 2009 letter from OMB Director Peter Orszag to House Budget Committee Chairman John Spratt.

[xi] The model is a large-scale econometric model of the U.S. economy. A detailed description of the model is available upon request.

[xii] The slump in consumer confidence after the recession in 1990-1991 may have been due in part to the first Bush administration's initial opposition to extending UI benefits for hundreds of thousands of workers. The administration ultimately acceded and benefits were extended, but only after confidence waned and the fledgling recovery sputtered.

[xiii] The economic bang for the buck estimates measure the change in GDP one year after spending actually occurs; they say nothing about how long it may take to cut a check to a builder for a new school.

[xiv] Spending safeguards proposed in the House stimulus plan include requiring governors and mayors to certify that expenditures under their jurisdiction are appropriate; program managers will be listed online so the public can hold them accountable; and a special board will monitor spending.

[xv] This analysis is based on a calculation of personal saving rates by income group using data from the Federal Reserve Board's Flow of Funds and Survey of Consumer Finance. Saving rates for those in the top quintile of the income distribution, most of whom did not receive a rebate check, rose significantly during this period as these households were already responding to their declining net worth. Saving rates for those in the bottom four quintiles did not increase significantly during this period suggesting they spent most of the tax rebate their received.

[xvi] There are no formal definitions of recession and depression, but the current period will likely be considered a depression if the nation's jobless rate rises into the double digits for more than two quarters.

Chairman SPRATT. Dr. Meyer, Laurence Meyer.

STATEMENT OF LAURENCE MEYER, PH.D.

Mr. MEYER. Thank you, Mr. Chairman.

Mr. Chairman, members of the committee, thank you for giving me this opportunity to share with you Macroeconomic Advisers' forecast of the economy over the next 2 years.

Chairman SPRATT. Would you pull the mike up?

Mr. MEYER. Our forecast incorporates a fiscal stimulus package that we designed to resemble very closely the plan that was proposed by the President-elect's then transition team. We think the effects of the House plan would be very similar.

Before proceeding further, let me remind you of what I am sure you already appreciate: Forecasting in the best of times is very challenging, and it is even more so today, given the uncertainties associated with the unprecedented shocks to the financial and real sector, uncertainties about the timing, aggressiveness and effectiveness of further non-conventional monetary policy actions and uncertainty about the size, timing and aggressiveness of the fiscal package.

Notwithstanding this uncertainty, we have to sort of begin in a disciplined fashion by trying to assess what the economy would most likely look like in the absence of fiscal stimulus and then offer a disciplined analysis of that stimulus, and that's what I hoped to offer today.

We are today almost certainly in a very deep recession, possibly the worst of the postwar period. We expect that real GDP declined at a 5½ percent rate last quarter. It is declining at about a 4 percent rate this quarter. In the absence of the fiscal stimulus, we expect that growth will remain weak for the rest of this year and then the economy will grow somewhat more strongly next year. The unemployment rate, which is now 7.2, would peak out at above 9 percent in the middle of next year and still be close to 9 percent at the end of next year.

By the way, we are viewed as optimists.

The economy is being weighed down by three powerful and interrelated shocks. The first is the housing correction, including the sharp decline in home prices. The second is a dramatic deterioration in credit conditions, including a sharp rise in credit risk spreads in the corporate bond and mortgage markets and a tightening in bank lending standards. The third is the very weak state of the banking system, with large losses, pressure on balance sheets and a potentially diminished flow of credit to households and businesses. The impact of these three weights has been amplified by the accompanying sharp decline in equity prices.

Now I would like to say we know why the economy will recover, we just don't know when. The recovery story has two parts. The first is an overwhelming policy response, fiscal as well as monetary. The second is diminished drag from the three weights discussed above: stabilization and then a rebound in housing from an extraordinarily low level, gradually improving credit conditions and some improvement in the health of the banking system.

The fiscal package we incorporate this forecast assumes a cumulative stimulus of $775 billion by the end of next year, including an increase in discretionary spending of about $250 billion and a cumulative increase in mandatory spending of about $200 billion and a cut in tax revenues of more than $300 billion.

To incorporate the fiscal stimulus into our forecast, we have had to assume spend-out rates for the various spending provisions, determine whether households and businesses will perceive the tax cuts, and indeed spending increases, as temporary or respond as if they are permanent, and let the model determine the expected effects on spending, employment and inflation.

We set the spend-out rates consistent with what we believed the transition team was aiming for. At the time, we didn't have the CBO spend-out rates. So we will certainly assess the spend-out rates in our forecast in light of the CBO's analysis, and presumably we will stream them out a little longer.

The effects on aggregate spending determined by the model are often described in terms of multipliers, that is, the increase in real GDP per dollar of spending or revenue loss. I note, however, that because almost all of the provisions in the fiscal stimulus package are temporary, it has a peak effect on the level of GDP, in 2010 in our forecast, and then the fiscal effects of the stimulus begins to slow growth relative to what otherwise would have been.

The effect of the fiscal stimulus, based on the assumed size, spend-out rates and model multipliers, is to raise the level of real GDP by about 3 percent by the end of 2010, to lower the unemployment rate by about 1¾ percentage points by the end of 2010, and to create 3.3 million jobs. This is at the upper end of the range that Doug Elmendorf talked about.

The projected stronger growth this year and next year allows the unemployment rate to peak at about 8½ percent at the end of this year and then to decline to about 7½ percent by the end of next year. While this is still well above estimates of the sustainable rate of full employment, the effect of the fiscal stimulus is still to speed the return to full employment and protect against the possibility that the economy will slip into deflation as early as next year.

Thank you.

Chairman SPRATT. Thank you very much for your excellent testimony.

[The prepared statement of Laurence Meyer follows:]

PREPARED STATEMENT OF LAURENCE H. MEYER, VICE CHAIRMAN, MACROECONOMIC ADVISERS

Chairman Spratt, Ranking Member Ryan and, and Committee members: Thank you for giving me this opportunity to share with you Macroeconomic Advisers' assessment of the near-term outlook for the economy. The forecast incorporates a fiscal stimulus package that we believe closely resembles the plan initially set out by the then President elect's transition team and we believe the plan being considered by the House would have a very similar impact. I have submitted for the record two reports that provide detail on our forecast and our analysis of the prospective fiscal stimulus.

Before proceeding further let me remind you of what I am sure you already know: Forecasting the macro economy in the best of times is challenging, but this is even more so today, given the unprecedented nature of shocks to the financial and real economy and uncertainties about the aggressiveness and effectiveness of non-conventional monetary policy options being pursued by the Fed and about the size, composition, and effectiveness of a prospective fiscal stimulus package. Nevertheless, in deciding whether to implement a fiscal stimulus package and how to calibrate its appropriate size, the point of departure should in our view be a disciplined assessment of how the economy would likely behave in the absence of the fiscal stimulus, followed by a disciplined analysis of the impact of the fiscal stimulus. This is what I hope to offer the Committee this morning.

We are today, almost surely, in a deep recession, possibly the worst in the post-war period. We expect that real GDP declined at about a 5½% annual rate in the fourth quarter of last year and will fall at about a 4¼% rate in the current quarter. In the absence of fiscal stimulus, we expect the economy would continue to decline slightly in the following two quarters, and begin to move to stronger growth next year. The unemployment rate, which is currently 7.2%, would peak at above 9% in the middle of next year and still be close to 9% at the end of next year. And, by the way, we are viewed as optimists.

The economy is being weighed down by three powerful and interrelated shocks. The first is the housing correction, including the sharp decline in home prices. The second is a dramatic deterioration in credit conditions, including a sharp rise in credit risk spreads in the corporate bond and mortgage markets and a tightening in lending standards at banks. The third is the very weak state of the banking system, with large losses, pressure on balance sheets, and potentially a diminished flow of credit to households and businesses. The impact of these three weights has been amplified by the accompanying sharp decline in equity prices.

I like to say we know why the economy will recover, we just don't know when. The recovery story has two parts. The first is an overwhelming policy response, fiscal as well as monetary. The second is diminished drag from the three weights discussed above: stabilization and then a rebound in housing from an extraordinarily low level; gradually improving credit conditions; and some improvement in the health of the banking sector, reflected in an and improved flow of credit to households and businesses.

Even with the assumed fiscal stimulus and diminishing drags, we expect a tepid recovery in the second half of this year, but a rebound to above trend growth in 2010. The unemployment rate in this case is expected to peak at about 8½% at the end of this year and decline to about 7½% at the end of 2010.

The fiscal package we incorporate into the forecast assumes a cumulative stimulus of $775 billion by the end of next year, including increase in discretionary spending of about $250 billion through 2010, a cumulative increase in mandatory spending of about $200 billion, and a cut in tax revenue of more than $300 billion.

To incorporate the fiscal stimulus into our forecast, we had to assume spend out rates for the various spending provisions, determine whether households and businesses will perceive the tax cuts (and indeed spending increases) as temporary or respond as if they are permanent, and then let the model determine the expected effects on spending, employment and inflation.

We set the spending pay-out rates consistent with what we believed the transition team was aiming for. We will reassess this in our next forecast round, in light of CBO's apparently lower assumed spend out rates for discretionary spending.

The effects on aggregate spending determined by the model are often described in terms of "multipliers", that is, the increase in real GDP per dollar of spending or revenue loss. Note however that, because almost all of the provisions in the fiscal stimulus package are temporary, it has a peak effect on the level of GDP, in 2010 in our forecast, and then the fiscal "stimulus" begins to slow growth relative to what it otherwise would have been for a period of time. I will be happy to elaborate on the multipliers for our model during the discussion that follows the opening statements, if the Committee wishes.

One important consideration in affecting the size of the multipliers is whether households and firms treat the tax cuts (and indeed spending increases) as transitory or permanent. We assume households respond to the increases in spending and to the cuts in personal taxes as if they were permanent, while businesses respond to the business tax cuts as if they were transitory. Given time, I would be happy to explain our treatment, but the decision here will have an important effect on the effectiveness of the stimulus package.

The effect of the fiscal stimulus, based on the assumed size, spend-out rates, and the model multipliers, is to raise the level of real GDP by about 3¼% by the end of 2010, to raise the growth rate over each of the next two years by about 1½ percentage points, to lower the unemployment rate by about 1¾ percentage points by the end of 2010, and to create 3.3 million jobs (that is, comparing the level of employment at the end of 2010 with what it would have been in the absence of fiscal stimulus).

The projected stronger growth both this year and next allows the unemployment rate to peak at about 8½% at the end of this year, and then to decline to about 7½% by the end of next year. While this is still well above estimates of the sustainable rate at full employment, the effect of the fiscal stimulus is still to speed the return toward full employment and protect against the possibility that the economy will slip into deflation as early as next year.

Chairman SPRATT. Our fourth witness is Kevin Hassett from the AEI.

Thank you very much for coming in. The floor is yours.

STATEMENT OF KEVIN A. HASSETT, PH.D.

Mr. HASSETT. Thank so much, Mr. Chairman. It is surely an honor to be here. I have submitted written remarks, and I will dance quickly to the highlights, knowing that it is a late hour.

I think that the headline of my remarks might be that I agree quite a bit with Mr. Blumenauer and with Ms. Rivlin, and I am going to explain why.

The NBER told us that the recession began in December of 2007. I think that we need to begin our discussion of where we are and where we might go from here with an acknowledgment that it is quite likely that that is a little bit early. And indeed, as I lay out in my testimony, I think that a model that has been really reliable in the past has called every recession correctly and never given a false signal suggests that the recession might have begun a little bit later.

The NBER itself has acknowledged that when in its announcement it said, and I quote now, "The committee found that the economic activity measured by production was close to flat from roughly September, 2007, to roughly June, 2008."

The reason that I mention June as a potential start for a recession is that when we are in a recession you kind of know what to expect. Mr. Chairman, you have been through some. And maybe a good one will last a year or a little bit less and a bad one will last a year and a half. I think that your mental clock should run from June, not from last December, as we look ahead.

Now if the recession truly began in June, then even if we receive a favorable draw, then we are talking something that is going to last well into the fall.

There is a strong reason to believe that we should count ourselves fortunate if this recession resembles anything like the typical recession, though. A new study by an economist at the IMF, which is cited in detail in my testimony, gathered data on 122 recessions in OECD countries between 1960 and 2007. The authors found that there had sadly been many historical precedents for the current crisis if you look at other countries. The recessions have been preceded by credit crunches before. Recessions have also been preceded by home price collapses and by equity price collapses. As you can see in figure 2 in my testimony, it has usually been the case that these negative forces have occurred in isolation.

Of the 18 recessions that followed credit crunches, three saw coincident housing price collapses and one saw a coincident equity price collapse and four saw all three negative factors, which is what we are looking at right now.

The key finding in the paper, however, is the significance of these factors in determining the outcome. Figure 3 shows how credit crunch recessions have differed over time from normal recessions, and news is not good. The typical decline and output during severe crunches and this episode again certainly qualifies as severe.

The last 4.3 quarters, which would take this one, if you believe it began in June, close to the end of the summer and post the GDP decline of more than 12 percent. Now these numbers might be large because of outliers. If one uses the median rather than the mean as the guide, then the average crunch lasts a little less than a year and posted about a 6 percent decline in GDP.

While this outlook is sobering, it is, if anything, a rosy scenario compared to other analyses. For example, a recent paper by economists Carmen Reinhart and Kenneth Rogoff focused exclusively on what could be called severe financial crises. Their key results are depicted in the next two charts.

Figure 4 looks at the typical unemployment experience for countries that have been through severe financial crises, and I think "severe" is probably an accurate description of the current one here. On average, the unemployment rate increased 7 percent and the downturn lasted a whopping 4.8 years.

If this chart characterizes the experience we are likely to have, then the unemployment rate in the U.S. would increase to about 12 percent. Employment is often slow to respond to improving economic conditions. Jobless recoveries are far too common. Thus, the unemployment rate may tell too negative a story.

However, figure 5 indicates that the record of GDP growth after financial collapses is also startlingly negative, with a typical decline in GDP being 9.3 percent and the typical downturn associated with financial crisis lasting almost 2 years.

And, again, figure 6 shows that this bad economic news has been very bad news for budget authorities. On average, a financial crisis has led to almost a doubling of outstanding government debt. It would take the 40 percent of GDP up to 80 percent almost or 70, 75 if we were to have a typical experience.

In this most recent budget outlook discussed by Mr. Elmendorf this morning, the CBO forecasts that GDP will decline 2.2 percentage points. I think that, given the history of financial crises, it seems that this estimate is probably more like a best-case scenario. Accordingly, I do encourage the members of this committee to be cognizant of the fact that the budget outlook is likely to deteriorate significantly as the year progresses and that it is going to look a lot worse maybe than the estimate right now by the end of the year.

Now that realization should not discourage this body from supporting fiscal policy action, but it is important to note that the average experience discussed above, those really bad numbers we just walked through, it is taken from a sample of countries that were governed by highly motivated policymakers dedicated to do everything they could to soften the economic downturn. Stimulus packages were probably passed in every data point that we saw there; and even with the shrewdest policy action the governments were able to devise, the experience was a lengthy and deep downturn far worse than what we see in the current CBO forecast.

I think there is a genuine concern that the economy will continue to be soft past the time when this year's stimulus efforts have had their effect and that deficits could be much larger than those currently forecast. We have not yet reached the point where sky-rocketing debt levels have caused heightened concerns among investors in U.S. Treasuries, but I think that there is a chance that we could push the envelope on it.

I am concerned that—and I am not one of those who thinks Keynesian stimulus has no effect and so on. But I am concerned that we might replace something like a slightly longer version of last year, where I do believe the second quarter GDP was stimulated by the stimulus package, that it did slow the onset of recession, but then the second half of the year we had a recession nonetheless. I am concerned that we could replay a similar episode, perhaps stretched out a little longer, and wake up and find the economy is still weak, given past history that would suggest the risks are significant.

So what does that make me want to do? I don't want to go into specific policy proposals. It is beyond the purview of my testimony. But I would like to say that I think and I agree with Ms. Rivlin that we shouldn't take long-run changes off the table, and the really obvious place to start is to give people some sense that in the long run we are going to return to fiscal discipline. But, also, there are other changes that one could make; and these are not things that I want to advocate in a way that creates a contentious conversation. But there are also permanent changes that one could make that could be good in the near term and the long term.

Now I will list two and close my testimony.

The first is that if you were to announce that a few years from now that you are going to have a value-added tax in the U.S.—this is a hypothetical—then today consumption might go up because people want to consume before the value-added tax happens. And in the long run you have extra tax revenue, given how high government spending to GDP is likely to be. It is probably the case that you will be looking for new sources.

Chairman SPRATT. Leave enough leave time and those who are opposed to it will all rally to support those who voted for it, and that day will never come.

Excuse me. Go ahead.

Mr. HASSETT. The second one, and then I will finish, sir, is if you were to announce that the corporate tax were going to be reduced in the future, something perhaps you wanted to head towards a target, as was in Mr. Rangel's bill last fall, of 31 percent, then if you were to reduce the corporate tax gradually over time, say a percent or two a year, then firms would deduct their capital spending today at the high rate and get their profits tomorrow at the lower rate. You would get a double positive effect from a long-run change.

And so I encourage you to think that, well, if this thing lasts longer than a few more quarters, then what would we wish that we had done? And I think that putting longer run things on the table, as Ms. Rivlin and I have suggested, is something that you might want to consider.

Thank you, sir.

[The prepared statement of Kevin Hassett follows:]

PREPARED STATEMENT OF KEVIN A. HASSETT, SENIOR FELLOW AND DIRECTOR OF ECONOMIC POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE

Chairman Spratt, Ranking Member Ryan and other members of the Committee, it is an honor to be afforded the opportunity to appear before you today at this critical moment in our nation's history.

The purpose of my presentation is to review the state of the economy, and to draw historical lessons from the academic literature to help sketch out the range of possibilities going forward.

It is always a perilous thing to opine on the state of the economy. The data that we use to assess the economy are published with significant lags. While we can now feel fairly certain about the character of the fourth quarter of 2008, the current quarter is still underway, and economies can and do change direction rapidly.

Accordingly, discussion of the current state of the economy should be cautious. However, there is one thing that is well established at this point. There is no debate among economists that we are currently in a recession. The National Bureau of Economic Research is the official arbiter of such matters, and they have dated the beginning of this recession to December 2007.

This determination is important, because economists have established that the economy tends to proceed in a "nonlinear" fashion; that is, we can think of history as having consisted of discretely different "good" times and "bad" times. When we are in good times, good quarters tend to follow good quarters. When we are in bad times, bad quarters follow one another.

The fourth quarter of last year was one of the worst quarters in memory. It is likely that GDP declined at an annual rate of around 6 percentage points. While there is little data in hand for the current quarter, a decline of a similar scale seems to be in order.

Bad times are here. But it is worth noting that declines of approximately this scale have been posted before. The economic data available do not suggest that we are in something fundamentally different from past recessions. It would not be unprecedented for GDP to decline six percentage points a quarter or two from the beginning of a recovery. For example, in the first quarter of 1958, GDP declined well over 10 percent at an annualized rate. In the second quarter of 1980, GDP declined by an annual rate of 7.8 percent.

How long will the recession continue this time? Is the outlook so negative that policy action is urgent and necessary?

At first glance, the history of recessions might provide some cause for optimism. The typical recession in post-war U.S. history lasted about 10 months. The worst two recessions, that of 1973 and that of 1981, both lasted about 16 months. If the recession truly began in December 2007, then one might expect that the recovery would be near.

There is cause, however, to be reluctant to accept such a rosy view.

The first cause is an important qualification to the NBER announcement. There is a good deal of uncertainty surrounding the precise start date of this recession. An alternative econometric approach pioneered by University of California economist Marcelle Chauvet, uses economic data to estimate the real-time probability that we are in a recession.[1] Her estimates clearly indicate that we are now in recession, but the start date may have been much later.

This latter possibility was acknowledged by the NBER when it announced that a recession had begun, writing that, "The committee found that economic activity measured by production was close to flat from roughly September 2007 to roughly June 2008."[2]

But if the recession truly began as late as June, then even if we receive a favorable draw and have an average recession by historical standards, then we can expect it to last into the summer. If this recession matches in duration the two worst post-war recessions, then it will last until October 2009.

There is a strong reason to believe that we should count ourselves fortunate if this recession resembles anything like a typical recession. A new study by economists at the IMF gathered data on 122 recession episodes in OECD countries between 1960 and 2007.[3]

The authors found that there have, sadly, been many historical precedents for the current crisis. Recessions have been preceded by credit crunches before. Recessions

[1] See Figure 1.
[2] *http://www.nber.org/cycles/dec2008.html*
[3] Claessens, Stinj, M. Ayhan Kose and Marco E. Terrones. "What Happens During Recessions, Crunches and Busts." IMF Working Paper, WP/08/274, December, 2008, *http://www.aei.org/docLib/20081212—IMF.pdf.*

have also been preceded by home price collapses, and by equity price collapses as well. As can be seen in figure 2, it has usually been the case that these negative forces have occurred in isolation.

Of the 18 recessions that followed credit crunches, three saw coincident housing price collapses, one saw a coincident equity price collapse, and four saw all three negative factors. The key finding of the paper is the significance of these factors in determining the outlook. Figure 3 shows how credit crunch recessions have differed over time from normal recessions.

The news is not good. The typical decline in output during severe crunches, and this episode certainly qualifies as severe, lasts 4.33 quarters, and posts a GDP decline of 12.38 percent. These numbers may be large because of outliers. If one uses the median, rather than the mean, as a guide, then the average severe crunch recession lasted 3 quarters, and posted a 6.15 percent decline in GDP. In comparison, the four recessions containing a house price bust, equity price bust and a credit crunch had an average duration of four quarters and a decline in GDP of 9.15 percent.

While this outlook is sobering, it is, if anything, a rosy scenario compared to other analyses. For example, a recent paper by economists Carmen Reinhart and Kenneth Rogoff focused exclusively on what could be called "severe financial crises." Their key results are depicted in the next two charts.

Figure 4 looks at the typical unemployment experience for countries that have seen severe financial crises. On average, the unemployment rate increased 7 percentage points, and the downturn lasted a whopping 4.8 years.

If this chart characterizes the experience we are likely to have, then the unemployment rate in the United States will increase to about 12 percent.

Employment is often slow to respond to improving economic conditions. Jobless recoveries are far too common. Thus, the unemployment data may tell too negative a story. However, figure 5 indicates that the record of GDP growth after financial collapses is also startlingly negative, with the typical decline in GDP being 9.3 percent, and the typical downturn associated with financial crisis lasting 1.9 years.

Figure 6 shows that this bad economic news has been very bad news for budget authorities. On average, a financial crisis has led to almost a doubling of outstanding government debt.

In its most recent budget outlook, the CBO forecasts that GDP will decline 2.2 percentage points. Given the history of financial crises, it seems that this estimate is probably more like a best case scenario. Accordingly, I encourage the members of the committee to be cognizant of the fact that the budget outlook is likely to deteriorate significantly as the year progresses.

That realization should not discourage this body from supporting fiscal policy action. But it is important to note that the average experience discussed above is taken from a sample of countries that were governed by highly motivated policymakers dedicated to doing everything they could to soften the economic downturn. Even with the shrewdest policy action that governments were able to devise, the typical experience was a lengthy and deep downturn.

There is a genuine concern that the economy will continue to be soft past the time when this year's stimulus efforts have had their effect, and that deficits could be much larger than those currently forecasted.

We have not yet reached the point where skyrocketing debt levels have caused heightened concerns among investors in U.S. Treasuries. If this Committee wishes to avoid testing those waters, it should consider tying stimulus efforts with genuine steps toward long run deficit reduction.

Figure 1.

Marcelle Chauvet – CREFC and University of California Riverside

Probabilities of Recession up to September 2008
using data available as of November 26, 2008

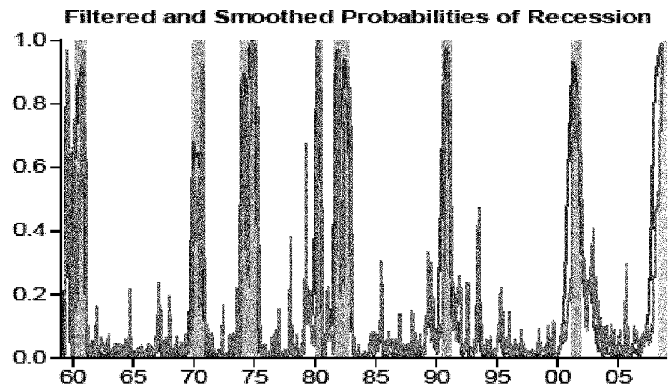


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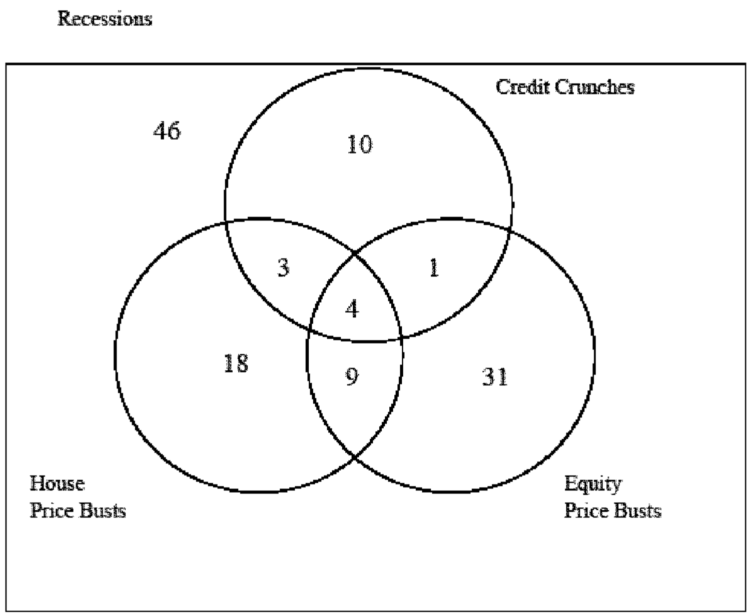
Figure 2.

Associations between Recessions, Crunches and Busts
(number of events in each event category)



Notes: The rectangle shows the distribution of 122 recession episodes in the sample into those associated with crunches and busts (76) and those associated with none (46). Out of 122 recessions, 18 are associated with credit crunches, 34 are with house price busts, and 45 are with equity price busts. 46 recessions are not associated with either a crunch or bust episode.

Claessens, Stinj, M. Ayhan Kose and Marco E. Terrones. "What Happens During Recessions, Crunches and Busts." IMF Working Paper WP/08/274, December, 2008, http://www.aei.org/docLib/20081212_IMF.pdf.

Associations between Recessions, Crunches and Busts (number of events in each event category) Claessens, Stinj, M. Ayhan Kose and Marco E. Terrones. "What Happens During Recessions, Crunches and Busts." IMF Working Paper WP/08/274, December, 2008, *http://www.aei.org/docLib/20081212—IMF.pdf.*

Figure 3.

Recessions Associated with Credit Crunches
(percent change unless otherwise indicated)

	Median Values			Mean Values		
	Without Crunches	With Crunches	With Severe Crunches	Without Crunches	With Crunches	With Severe Crunches
A. Output						
Duration [1/]	3.00	3.00	3.00	3.64	3.78	4.33
Amplitude	-1.82	-2.19	-2.7*	-2.47	-3.71	-4.05
Cumulative Loss	-2.87	-4.44*	-6.15**	-6.03	-8.85	-12.38
B. Components of Output						
Consumption	-0.04	-0.41	-0.58	-0.19	-0.16	0.79
Total Investment	-3.98	-4.97	-3.83	-5.90	-5.61	-4.70
Residential Investment	-3.72	-7.42	-8.16	-6.38	-8.92	-10.04
Non-residential Investment	-3.58	-4.25	-1.66	-5.12	-4.00	-1.40
Exports	-0.55	-1.82	-1.13	-0.65	-2.22	-2.01
Imports	-3.64	-4.55	-3.23	-3.81	-6.08	-7.07
Net Export (% of GDP) [2/]	0.48	1.06	1.17	0.67	1.10	1.48
Current Account (% of GDP) [2/]	0.45	0.88	1.39	0.57	0.42	1.65
C. Other Macroeconomic Variables						
Industrial Production	-4.02	-5.68	-6.48**	-3.84	-5.30	-6.58**
Unemployment Rate [2/]	0.55	0.90	1.00	1.14	0.89	0.83
Inflation Rate [2/]	-0.31	-0.33	0.53	-0.38	0.20	0.79
D. Financial Variables						
House Prices	-1.82	-4.04**	-4.88	-3.08	-6.38	-8.11
Equity Prices	-6.28	-2.47	7.88**	-4.30	-1.19	6.78**
Credit	1.54	-4.25***	-4.85***	2.82	-4.9***	-5.73**

Notes: Severe credit crunches are those that are in the top half of all crunch episodes. In each cell, the mean (medi change in the respective variable from peak to trough of recessions associated with credit crunches is reported, unle otherwise indicated. The symbols *, **, and *** indicate that the difference between means (medians) of recession with credit crunches and recessions without credit crunches is significant at the 10 percent, 5 percent, and 1 percent levels, respectively.

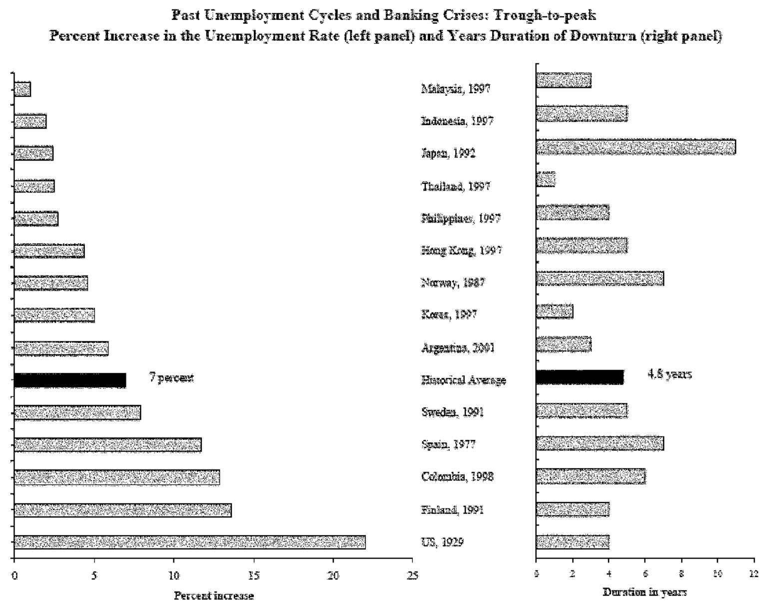
[1/] Number of quarters.

[2/] Change in levels.

Claessens, Stinj, M. Ayhan Kose and Marco E. Terrones. "What Happens During Recessions, Crunches and Busts." IMF Working Paper, December, 2008, http://www.aei.org/docLib/20081212_IMF.pdf.

Recessions Associated with Credit Crunches (percent change unless otherwise indicated) Claessens, Stinj, M. Ayhan Kose and Marco E. Terrones. "What Happens During Recessions, Crunches and Busts." IMF Working Paper, December, 2008, *http://www.aei.org/docLib/20081212—IMF.pdf.*

Figure 4.



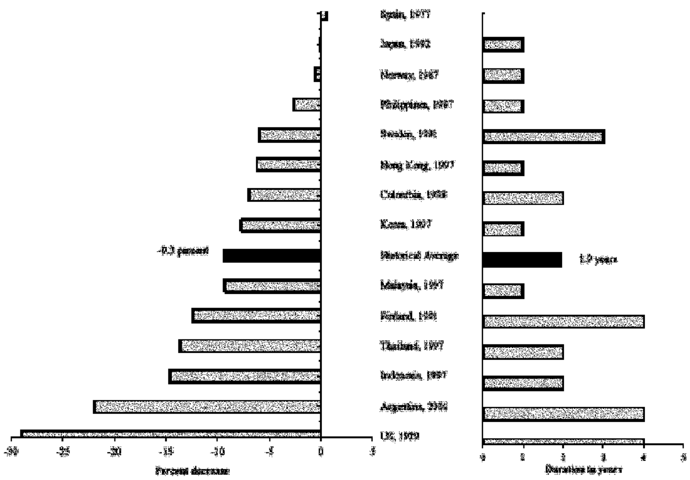
Reinhart, Carmen M. and Kenneth S. Rogoff. "The Aftermath of Financial Crisis." National Bureau of Economic Research Working Paper 14656. January, 2009, www.nber.org/papers/w14656.

Reinhart, Carmen M. and Kenneth S. Rogoff. "The Aftermath of Financial Crisis." National Bureau of Economic Research Working Paper 14656. January, 2009, *www.nber.org/papers/w14656.*

Figure 5.

Past Real Per Capita GDP Cycles and Banking Crises: Peak-to-trough

Percent Decline in Real GDP (left panel) and Years Duration of Downturn (right panel)



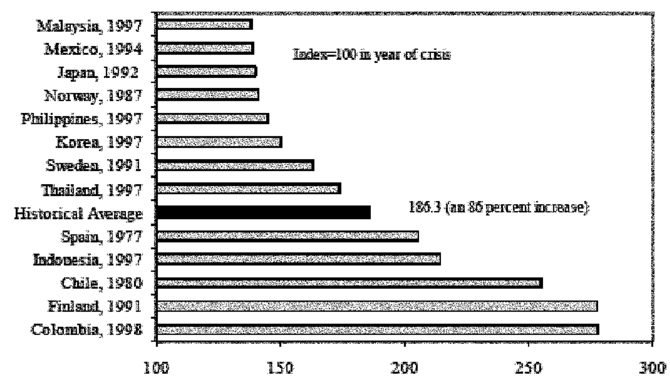
Sources: Total Economy Database (TED), Historical Statistics of the United States (HSOUS), and authors' calculations.
Notes: Each banking crisis episode is identified by country and the beginning year of the crisis. Only major (systemic) banking crises episodes are included, subject to data limitations. The historical average reported does not include ongoing crises episodes. Total GDP, in millions of 1990 US$ (converted at Geary Khamis PPPs) divided by midyear population.

Reinhart, Carmen M. and Kenneth S. Rogoff. "The Aftermath of Financial Crisis." National Bureau of Economic Research Working Paper 14656. January, 2009, www.nber.org/papers/w14656.

Reinhart, Carmen M. and Kenneth S. Rogoff. "The Aftermath of Financial Crisis." National Bureau of Economic Research Working Paper 14656. January, 2009, *www.nber.org/papers/w14656.*

Figure 6.

Cumulative increase in real public debt in the three years following the banking crisis



Sources: Reinhart and Rogoff (2008b) and sources cited therein.
Notes: Each banking crisis episode is identified by country and the beginning year of the crisis. Only major (systemic) banking crises episodes are included, subject to data limitations. The historical average reported does not include ongoing crises episodes, which are omitted altogether, as these crises begin in 2007 or later, and debt stock comparison here is with three years after the beginning of the banking crisis.

Reinhart, Carmen M. and Kenneth S. Rogoff. "The Aftermath of Financial Crisis." National Bureau of Economic Research Working Paper 14656. January, 2009, www.nber.org/papers/w14656.

Reinhart, Carmen M. and Kenneth S. Rogoff. "The Aftermath of Financial Crisis." National Bureau of Economic Research Working Paper 14656. January, 2009, *www.nber.org/papers/w14656.*

Chairman SPRATT. Well, you gave us some very dire descriptions of the current economy. Where do you stand or would you stand if you had a vote to cast tonight on the stimulus legislation before us?

Mr. HASSETT. Without having read the whole thing, sir, I am sorry, I can't say. I support and agree that a Keynesian stimulus right now would have a positive effect.

Chairman SPRATT. Your testimony was a little elliptical, but I kept sensing you were coming around to that point of view. Thank you for your testimony.

Mr. Blumenauer has a couple of questions.

Mr. BLUMENAUER. Actually, I just wanted to follow up particularly on what Ms. Rivlin mentioned but also Mr. Zandi and our final witness.

We have got a situation now where the notion of having entitlement reform, if we are going to, for example, tying the notion of a tax holiday, a payroll tax holiday, but 4 or 5 years out we will lift the ceiling. We will make some other adjustments so that it looks like we are moving.

The other that I would welcome your thoughts and perhaps follow up at a later date, because I don't want to keep you trapped here, deals with a package for funding long-term infrastructure. We have a Highway Trust Fund that is in deficit for the first time in its history. There seems to be a growing consensus from the private sector and the public sector for making some adjustments for road-related or transportation-related fees,that we might be able to use that to enact and have a long-term reauthorization that might be twice the size that it is now but paid for, for transportation. Do a couple of bites of the entitlement reform tied with a tax, a payroll tax holiday. Any sense on the transportation package or tying those two together moving forward?

Ms. RIVLIN. Well, let me take a stab at it.

I hadn't thought of tying entitlement reform to the payroll tax holiday, although I favor both, so I think this is a good idea. The payroll tax holiday I think gets money to the right people quickly and is clearly reversible because, unless you are going to go to some totally different way of financing Social Security, you need to get it back. And so for that reason I think it is a very good idea.

And I think you could tie it to long-run entitlement reform in the form of the package of things that I mentioned that would be out in the future, some of them quite far in the future. We haven't finished with the reforms we did in 1983. And so I think that is a good idea. Now the payroll tax holiday makes it necessary to do even more on the long-run changes.

Funding for long-term infrastructure, I am one who thinks we need something like a carbon tax. And, again, we don't want to raise taxes. Right now would be a bad moment. But I have thought for years that doing something that was a scheduled long-term increase—I had been thinking in terms of the gas tax—but whatever tax scheduled out in front would be a very sensible thing to do, because we want to encourage conservation over time.

And the other piece of that I think can be a serious effort to fund metropolitan transportation infrastructure with congestion fees.

Mr. BLUMENAUER. Mr. Chairman, I appreciate your courtesy. I look forward to following up with some of our panelists how this might be packaged. Thank you very much.

Chairman SPRATT. We now have a series of votes, four votes, unfortunately; and I am not going to ask you for further forbearance.

I want to thank you for coming. I assure you that what you said will be put to use. In fact, if you listen to the debate tonight and tomorrow, you may hear yourself repeated without acknowledgment. Who knows? In any event, you have helped us understand the situation of the choices before us; and we look forward to working further with you on the solutions to the problems that confront us. Thank you very much for your patience.

I ask unanimous consent that members who did not have an opportunity to ask questions of witnesses be given 7 days to submit questions for the record. You don't have to answer them.

Thank you very much indeed.

[Whereupon, at 2:10 p.m., the committee was adjourned.]

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